Regulation of Reinsurance in Taiwan: Developing an Appropriate Regulatory Environment for Maintaining the Solvency of Primary Insurers

Wang, Hsin-Chun

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Hsin-Chun Wang

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Supervisor: Professor Joseph J. Norton, S.J.D, D.Phil., LL.D (hc).
Centre for Commercial Law Studies-QMUL

Abstract

Unlike other financial services (*e.g.,* services provided by a bank or a primary insurance company), reinsurers seldom deal with the consumers directly. This indirect relationship with the consumer results in the view that it is not necessary to regulate pure reinsurers to the same degree as primary insurers, because they deal only with other companies or individuals in the insurance business who are already subject to regulatory control. It is true that a reinsurer bears its own risk; however, if a reinsurer becomes insolvent or has not provided sufficient reserves to cover liability of payments, the stability of the primary insurer might be threatened and hence the interests of the insured parties.

In the last decade or so, reinsurance markets have been dominated by a number of trends, which include an increase of the potential risk of liability of "long-tail" catastrophe (*e.g.,* earthquake, hurricane and flood) and significant uncollectible reinsurance recoverables due to legal disputes relating to contract liability. These factors have affected solvency margins of primary insurers. At the same time, there has been a rapidly growing concern respecting "finite risk" reinsurance and securitisation of insurance risk, which can be tailored more specifically to the needs of the insurers.

With regard to emerging markets, reinsurance regulation currently tends to be based on local protectionism. This has impeded the diversification of insurance risk and has resulted in a shortage of capital capacity to cover further risks. In addition, trade barriers as to reinsurance have been gradually dismantled by the efforts undertaken by many international negotiations and organisations (e.g., WTO and OECD) in recent years. On the other hand, with insurance regulation being gradually built, internationally on a set of pro-competitive principles designed to ensure a competitive, solvent and fair market, the reinsurance market is becoming more competitive.

In order to establish a sound and viable regulatory regime, emerging countries are seeking to implement regulatory reform based on several leading regulatory models which have been proved effective in developed countries (*e.g.*, the UK and USA models). It is evident, however, that the attempts merely to copy the "ready-made" law of industrialised countries will fail unless awareness of particular social, economic and legal differences are taken into account.

The primary theme of this volume is that the traditional point of view that private reinsurers and reinsurance markets are not in need of governmental regulation is flawed. To the contrary, the reinsurers, reinsurance intermediaries and related reinsurance arrangements should be appropriately regulated to protect the solvency of primary insurers. Through comparative analysis of different sets of international regulatory principles and of experienced developed country models, this volume will develop and address these general regulatory issues. In order to provide and to enact a sound and viable regulatory system in emerging markets, however, such regulations should be adopted to suit the particular country circumstances and should not be imposed or copied *en masse* from existing models. In support of this proposition, the example of the Taiwanese reinsurance market will be used as a case study.

Unless otherwise indicated, this volume speaks as of September 2001.

DEDICATION

To my parents (Ching-Chuang Wang and Yu-O Wangchen)
and wife (Shu-Ching Chan)
for their strong and continuing love and support

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Introduction

Reinsurance[1] is mainly designed to transfer insurer's risk to reinsurers[2]. In addition to this main purpose, other ancillary functions include improving insurers' capacity[3] of obtaining business, stablising insurers' profits[4], strengthening their financial

[1] To achieve a satisfactory legal definition of reinsurance is more problematic, particularly in the definition of "subject matter" of reinsurance. It has been scrutinised that " The English authorities do not provide a satisfactory definition of reinsurance, and the evolution of reinsurance in its various forms has made it difficult to achieve a comprehensive definition." *See* MacGILLIVRAY ON INSURANCE LAW 888 (Nicolas Legh-Jones et al. eds., 9th ed., 1997). There are several aspects to achieve a narrow legal definition of reinsurance. It has been proposed in the following working hypothesis. " (1) A reinsurance contract is a transaction involving the transfer of risk which is governed by the legal principle of *uberrima fides*. (2) The transferor (the reinsured) transfers risk to one or more transferees (the reinsurer/s) in consideration for the payment of money (the reinsurance premium). (3) The risk that the reinsured transfers may arise either (a) under a contract or contracts of insurance, or a contract or contracts of reinsurance, which contracts the reinsured has entered into before the making of the reinsurance contract; or (b) following the making of the reinsurance contract, under future contracts of insurance or reinsurance, which are in the contemplation of the parties at the time the reinsurance contract is made. (4) The reinsurance contract under which the risk is transferred is separate and distinct from the insurance or reinsurance contract or contracts under which the reinsured has assumed the risk. (5) The reinsurer may assume 100 per cent, which the reinsured has assumed, or will in the future assume, under a contract or contracts of insurance or reinsurance. (6) The nature and extent of the obligation of the reinsurer to pay money to the reinsured is defined solely by the terms of the particular reinsurance contract. (7) There will frequently be elements of reinsurance which do not constitute an acceptance of the reinsured's "insurable interests" in the underlying subject matter." P. T. O'NEILL, & J. W. WOLONIECKI, THE LAW OF REINSURANCE IN ENGLAND AND BERMUDA 24-25. (1998).

[2] Reinsurance has been simply described as " insuring insurance". "It is (1) the business of insuring an insurance company or underwriter against suffering too great a loss from their insurance operations; and (2) allowing an insurance company or underwriter to lay off or pass on part of their liability to anther insurer on a given insurance which they accepted." *See* ROBERT KILN & STEPHEN KILN, REINSURANCE IN PRACTICE 1 (4th ed. 2001). An insurer, however, can suffer a great loss under the protection of reinsurance only through laying off or transferring its risk to reinsurers,. Accordingly, the main function of reinsurance is to lay off (or transfer) risk to reinsurers. *See generally* P. T. O'NEILL, & J. W. WOLONIECKI *supra* note 1, at 3. *See also* KEITH RILEY, THE NUTS AND BOLTS OF REINSURANCE 2-3 (1997); R. PHILIPPE BELLEROSE, & KENNETH V. LOUW, REINSURANCE FOR THE BEGINNER 1-5 (1998); LEALIE LUCAS, JOHN McLEAN, & PETER GREEN, REINSURANCE MANAGEMENT 1-2. (1996); R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, REINSURANCE 3 (4th ed., 2000). Reinsurance also is thought of as "insurance for an insurance company" MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON, & PERTER R. KENSICKI, PRINCIPLES OF REINSURANCE Volume I 1 (July 1995).

[3] In the insurance industry, the insurance company insures the whole risk itself and transfers or lays off some of the amount it has accepted to other insurers or reinsurers. Through this arrangement, insurers can obtain business when they cannot afford to keep the whole of the insured value for its own account or meet the solvency margins. Such risks are numerous: aircraft, ship and satellites are some of the best examples. *See generally* R. PHILIPPE BELLEROSE, & KENNETH V. LOUW, *supra* note 2, at 1-2.

[4] " Insurance losses sometimes fluctuate widely because of demographic, economic, social, and natural forces as well as simple chance. Smoothing the peaks and valleys of a primary insurer's random variation in loss experience helps ensure steady profits." MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON, , & PERTER R. KENSICKI, *supra* note 2, at 3. For example, when an unexpected accumulation of losses or of single catastrophic losses occurs during the certain period, reinsurers will absorb these losses to smooth the peaks and valleys of insurers profits through the reinsurance contract. *See* R. PHILIPPE BELLEROSE, & KENNETH V. LOUW, *supra* note 2, at

solvency[5], and providing technical service[6].

The object of reinsurance is to spread risk domestically or even internationally.[7] Particularly in some developing countries, foreign reinsurers with greater experience can support a new, growing insurer not only to increase this insurer's capacity, but also to improve its technical experiences (*e. g.*, underwriting and pricing of products)[8]. Unlike other financial services (*e.g.*, those supplied by banks, and primary insurance companies), reinsurers seldom deal with the consumers directly. "This less direct link to the consumer leads to the view that pure reinsurers do not need to be regulated to the same degree as insurers because they deal only with other companies in the insurance business who are themselves not neophytes and are already subject to regulatory control.[9]"

Reinsurers bear their own risk, however, if reinsurers become insolvent or

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3. (1998). *See also* P. T. O'NEILL, & J. W. WOLONIECKI *supra* note 1, at 4. KEITH RILEY, *supra* note 2, at 2-3.

[5] The example which explains how reinsurance can improve the solvency margin of insurers is as following:

An insurer has capital and free reserves of $4 million. The annual premium is $ 20 million.

The solvency ratio without reinsurance would be 20% (4 million/20 million=20%) If it has reinsurance which allows annual premium cession of 4 million, the net retained premium will be $16 million ($20million less a cession of $4 million). The ration of solvency margin would increase to 25% (4 million/16 million=25%).

See R. PHILIPPE BELLEROSE, & KENNETH V. LOUW, *supra* note 2, at 4-5. *See also* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 4. (1998). LEALIE LUCAS, JOHN McLEAN, & PETER GREEN, *supra* note 2, at 1-2.

[6] Insurers can obtain the knowledge from large reinsurance companies and some reinsurance brokers which have an international experience of insurance business, particular in some developing countries. The technical service which reinsurers or reinsurance brokers provide can be divided into three parts which are as following:

(1) Risk underwriting—For example, nuclear insurance that requires a particular underwriting experience is often beyond the insurer's expertise.
(2) Claims handling—In particular for the claims due to legal liability (e.g., professional liability, product liability) or the specialist classes (e.g., pollution), insurers lack skills and experience on these claims.
(3) Technical research—Reinsurers often publish the results of research on technical matters to improve insurers' experiences.

See LEALIE LUCAS, JOHN McLEAN, & PETER GREEN, *supra* note 2, at 7-8. Besides the technical service mentioned above, the service range also includes setting accounting procedure and the training of staff. *Cf.* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, supra note 2, at 12.

[7] For example, if a catastrophe (e.g., earthquake, flood, and hurricane) occurs in one country and causes huge losses beyond the capacity of this country, it is necessary to transfer the catastrophe risk to a number of foreign reinsurers who can share the risk before the earthquake occurs. Reinsurance can be thought as a "worldwide risk sharing" tool. MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON, , & PERTER R. KENSICKI, *supra* note 2, at 12.

[8] UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, SUPERVISION OF INSURANCE SUPERVISION OF INSURANCE OPERATIONS-A MANUAL TRAINEE STAFF OF INSURANCE SUPERVISORY AUTHORITIES, Module 3, at 14 (1996).

[9] P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 660.

have not provided sufficient resources to cover liability of payments, the stability of the primary insurers would be threatened and hence the interests of the insured parties. In the last decade or so, the global reinsurance market has been dominated by several significant trends, including the crisis in US liability insurance[10] and exceptional losses from natural catastrophe (e.g., earthquake, hurricane and flood)[11]. These changes have impaired the financial condition of many reinsurers[12] and have resulted in an increase of legal disputes between reinsurers and primary insurers[13]. These adverse impacts have consequently affected adversely the solvency margins of "ceding" insurance companies. Historical evidence shows that several significant insolvency cases have resulted in uncollectible reinsurance for primary insurers during the 1980s[14]. This illustrates the importance of reinsurance collection[15] in the context of solvency of primary insurers[16] and the necessity for supervision of

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[10] During 1980s, the loss ratios in the US liability insurance rose dramatically due to higher claims relating to asbestos and environmental impairment loss. The trend in US court rulings to grant increasingly higher compensation to injured parties exacerbated the existing problems. These major changes consequently caused insurers to unexpectedly increase their loss reserve, and "the legal uncertainties in the writing of new business led to severe capacity shortage in the US insurance market and in the reinsurance market especially." *See* Swiss Re, *The Global Reinsurance Market In The Midst Of Consolidation*, 9 SIGMA 1, 12 (September/1998).

[11] In the last ten years, the property insurance industry in the USA market has paid out over $60 billion in losses due to increasingly severe catastrophes such as hurricane Andrew (1992, $16 billion), the Northridge earthquake (1994, $12.5 billion), hurricane Opal (1995, $2.1 billion), and hurricane Fran (1996, $1.6 billion). See Michael S. Canter, Joseph B. Cole and Richard L. Sandor, *Insurance Derivatives: A New Asset Class for the Capital Markets and a New Hedging Tool for the Insurance Industry*, Hedge Financial Products Inc. (last visited 10 March, 2002) *available at* <http://www.cnare.com/rescenter/s2k_reports/s2k_insderivatives.htm>.

[12] *See* R. C. L. Bakker and H. J. M. Teeuwen, *The IAIS Survey on Reinsurance Supervision: An Overview of the Finding,* 23 THE GENEVA PAPERS ON RISK AND INSURANCE NO. 89, at 613 (Oct/1998). *See also* Swiss Re, *supra* note 10, at p.14.

[13] In the insolvency cases of Mission and Integrity in 1984 to 1988, the US House of Representatives Energy and Commerce Subcommittee on Oversight and Investigations Staff Memorandum on the Subcommittee's investigations of the failures, states, "....... both insurers used complex arrangements involving hundreds of reinsurers around the world to transfer most of the risk on the extremely unprofitable business they were underwriting. When huge losses started to accrue, Mission and Integrity were required to pay the entire amounts because their reinsurers refused to pay. The reinsurers have alleged fraud and misrepresentation as justification for not paying, but the ultimate result was to force Mission and Integrity into bankruptcy because of their inability to collect reinsurance proceeds." See JOHN MILLIGAN-WHYTE, G. L. SMITH, & STEPHEN LEWIS, *Transnational Aspects Of Insurance And Reinsurance Insolvencies: An Introductory Overview Of Selected Issues From Bermudian, American, And English Perspectives,* ALI-ABA COURSE OF STUDY, US – CANADIAN BUSINESS LITIGATION ISSUES: A COMPARATIVE VIEW 327, at 344-345(The American Law Institute, C475 ALI-ABA 327, 16 Nov. 1989).

[14] *See* MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON, , & PERTER R. KENSICKI, PRINCIPLES OF REINSURANCE Volume II 193 (July 1995).

[15] In brief, the issue of reinsurance collection falls into two categories: one is that reinsurers do not have the ability to pay because of insolvency of reinsurers; the other is that reinsurers will not pay due to legal dispute arising from the reinsurance contracts. *See* LEALIE LUCAS, JOHN McLEAN, & PETER GREEN, *supra* note 2, at 4.

[16] Some articles indicate that the reinsurance collection is one of the causes of insolvencies. "There are

reinsurance activities. Under such a scenario, for the purpose of consolidating the solvency margin of insurers in the reinsurance operations, it is essential for insurers and their regulators to concentrate on the evaluating reinsurers' solvency.

At the same time, there is an innovative reinsurance product that was known as "financial reinsurance" during 1980s and is now frequently expressed in the term- "finite risk reinsurance"[17]. As the use of this arrangement especially could optimize the reinsurer's balance sheet and could contradict the "true and fair view" insurance accounting principle in some cases, it is gaining increasing attention from supervisors and tax authorities. The initial function of reinsurance is to transfer liability for potential future losses arising from actual insurance underwriting risks[18] along with the premium corresponding to such risk. *Finite risk reinsurance*, however, mainly transfers finite risk[19] that could affect the reality of future profits (*e.g.,* investment and interest profits) of insurance companies from future loss payments through deterioration of the insurers' loss reserves. This controversial type of reinsurance contract today plays an important role in the issue of reinsurance regulations and

several key factors common to insolvent companies. 1.Inefficiencies in middle and upper management; 2.Poor planning; 3.Rapid over-expansion and diversification; 4.Under-capitalisation; 5. Poor investment policies; 6.Inadequate pricing; 7. Under reserving; 8. Failure on the part of management to monitor managing general agents; and 9. Inability of ceding companies to collect reinsurance recoverables. " *See* FRANCINE L. SEMAYA & JOHN S. PAK, *Reinsurance Litigation: Current Issues and Strategies-Current Trends in the Regulation of Reinsurance Insolvencies, in* REINSURANCE LITIGATION 1995, 51, at 54-55. (Reinsuarnce Ligation and Arbitration, Commercial Law and Practice Course Handbook Series, 717 PLI/Comm 51, Practising Law Institute, May 1995). According to the AM Best's report, reinsurance collection is also a primary cause of insolvency. This report describes 8 primary causes of insolvencies. 1. Deficient loss reserves(Inadequate pricing); 2. Rapid growth; 3. Alleged Fraud; 4.Overstated assets; 5. Significant change in Business; 6. Reinsurance Failure; 7. Catastrophe losses; and 8. Impaired affiliate. *See* A.M.BEST, *Insolvency: Will Historic Trends Return* in A.M.BEST SPECIAL REPORT February 1999, at 1-5 (Martin P. Sheffield, et al. eds., Feb., 1999).

[17] "Finite risk and financial reinsurance are synonymous because a very limited amount of risk, underwriting risk, is transferred along with the financial concern." ROSS PHIFER, REINSURANCE FUNDAMENTALS-TREATY AND FACULTATIVE, 99 (1996). The expression "finite risk" is now frequently used as an equivalent for or alternative to "financial reinsurance". *See* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 660. "While underwriting risk played only a subordinate role in (pure) financial reinsurance contracts up to the beginning of the nineties, it has meanwhile become an integral component of finite risk reinsurance." *See also* Swiss Re, *Alternative Risk Transfer via Finite Risk Reinsurance: An Effective Contribution To The Stability Of The Insurance Industry*, 5 SIGMA 1, 11 (1997).

[18] "Underwriting risk is against the resulting economic damage from a defined peril, which may range from smoke damage to hurricane wind, from slander to malpractice." ROSS PHIFER, *id* at 99.

[19] There are several types of finite risk. For example, investment return risk is the uncertainty as to the ultimate investment return which a reinsurer will earn, other than by reason of the timing risk, on net moneys accruing under a reinsurance contract. *See* THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES, ACCOUNTING FOR NON-LIFE FINANCIAL REINSURANCE: A DISCUSSION PAPER 6 (1992).

solvency regulations[20].

In addition to finite risk reinsurance, the *securitisation* of insurance risk has raised considerable concerns for investors, insurance undertakings, regulators, and accountants since the major landmark insurance-linked securities carrying a "rating" on the underlying catastrophe risk-USAA (United Services Automobile Associations as a primary insurer) and Residential Reinsurance (as a reinsurer) was launched in June 1997[21]. In general, a "special purpose vehicle" is created not only to provide reinsurance coverage for the ceding insurers but also to issue insurance-linked securities to the investors. A trust is also created for collecting funds from the investors while the ceding insurer pays a premium to the SPV in exchange for reinsurance coverage. The ultimate return can be based on the actual loss of the ceding insurer, the performance of the related index, the occurrence or non-occurrence of the specific event, or the physical parameters of the natural hazard[22].

As a result of the dramatic increase in these securitisation transactions, regulators have been challenged significantly to develop an appropriate regulatory approach to supervise these activities.

With regard to emerging markets, reinsurance regulation tends to be based largely on local protectionism. This has impeded the diversification of insurance risks and has resulted in a shortage of "capacity" in these markets. Yet, globally, the trade barriers on reinsurance have been gradually dismantled by the efforts undertaken in various international negotiations and in various international organisations in recent years. Further, globally, insurance regulation is being gradually built on a set of pro-competitive principles designed to ensure a competitive, solvent and fair market; and in fact, the reinsurance market seems globally to be more competitive than before. Thus, particularly in emerging markets, it is becoming essential to establish a

[20] For example, the Insurance Committee in the OECD discusses major recent policy issues in solvency regulations which include financial reinsurance. See OECD, INSURANCE IN FINANCIAL, INVESTMENT, TAXATION AND COMPETITION, at 3, (last visited 12 April 1998) available at http://www.oecd.org/search97cgi/s97_cgi

[21] By gaining "double B" ratings from the main rating agencies, this transaction successfully represented that insurance-linked securities had become the significant part of investment grade securities and had opened up the market to diversify the investors' portfolio. *See* GARRY BOOTH & CHARLES ALLARD, INSURANCE RISK SECURITIES– A GUIDE FOR ISSUERS AND INVESTORS 17 (1999). *See also* Michael S. Canter, Joseph B. Cole, and Richard L. Sandor,, *supra* note 11.

[22] *See* Eduardo Canabarro, Markus Finkemeier, Richard R. Anderson & Fouad Bendimerad, *Analyzing Insurance-linked Securities*, FINANCING RISK & REINSURANCE, September 1999, at 5(1999).

comprehensive and viable regulatory system to provide a "safe and sound" flooring to this increasingly liberalised and competitive environment.

In order to establish a sound and viable regulatory regime, emerging countries have sought to draw from several leading regulatory models, which have been proved effective in developed countries (e.g., in the UK and USA). It is evident, however, that the attempts to copy literally and uncritically the "ready-made" law of industrialised countries will fail unless awareness of social, economic and legal differences has been taken into account[23]. In terms of reinsurance regulation in emerging markets, adaptation of developed models and international regulatory principles should take into account the particular market characteristics and legal differences in a particular emerging market.

The primary theme of this volume is that the traditional point of view that private reinsurers and reinsurance markets are not in need of governmental regulation is flawed; to the contrary, reinsurers and related reinsurance arrangements should be appropriately regulated to protect the solvency of primary insurers. Analyses of international regulatory principles and experienced developed country models will help address these general regulatory issues. In order to provide and to enact a sound and viable regulatory system in emerging markets for reinsurance, however, such regulations should be adapted to the particular circumstances and should not simply be imposed or copied wholly all from the existing models.

In support of this proposition, the example of the Taiwanese reinsurance market will be used as a "case study". In the case of Taiwan, which has common characteristics with many other emerging markets, there is a pre-existing regulatory system and a particular market environment that can not be ignored. With regard to the Taiwanese reinsurance market, the trends and lessons arising from the recent Asia financial crisis and liberalisation of trade in financial services will also be addressed.

The current emphasis on fundamental financial sector reform in Asian economies[24] has had a striking impact on the expansion plans of many insurers and reinsurers in its Asia-Pacific area. Also, influencing such plans are several major

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[23] See JOSEPH J. NORTON, FINANCIAL SECTOR LAW REFORM IN EMERGING ECONOMIES 130-132 (2000).
[24] *See* THOMAS J. T. BALINO, CHARLES ENOCH, ANNE MARIE GULDE, CARL-JOHAN LONDGREN, MARC QUINTYN, & LESLIE TEO, ADVANCE COPY: FINANCIAL SECTOR

trends: *e.g.*, deregulation occurring in a number of emerging markets, the potential reduction of restrictions on financial service transaction worldwide, and the implementation of the World Trade Organization agreement ("GATS") calling for the dismantling of barriers to trade in financial service by countries participating in this agreement[25]. Due to these trends, non-life reinsurance demand has continued to rise and real growth in "cession volume" is even higher than that in direct premiums[26] in recent years. All this makes the Asia-Pacific market increasingly important in global reinsurance market. In 1997, Asia-Pacific's share of global ceded business in non-life reinsurance market reached 12.1%[27]. With regard to the reinsurance market in Taiwan, which plays an important role in this region, the average rate of risk retention in the last decade is about 50%[28]. The transfer (ceding) of risk abroad is now a common industry market practice in Taiwan. Yet, as a matter of fact, the regulation of reinsurance in Taiwan still appears less developed than in developed countries. It is accordingly essential to introduce an adequate regulatory framework for reinsurance, *inter alia* to protect solvency of insurers in Taiwan. This is needed to maintain the continued stable operation of the Taiwanese insurance and reinsurance market, as well as of the Taiwanese economy as a whole.

For comparative purposes, this volume will explore selective developed models for reinsurance regulations and will analyse the related regulatory issues especially with regard to solvency requirement of insurers in reinsurance arrangements. Drawing from these models, this volume will recommend possible regulatory reform as to the current Taiwanese reinsurance regulation, taking into account its particular economic environment and legal system. From this, broader lessons may be learned by other emerging economies

To facilitate the development of its primary and related themes, this volume will be organised into five chapters. In order to provide a theoretical basis for examining the main issues in the succeeding Chapters, Chapter One will analyse the

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[25] See A GUY CARPENTER, GLOBAL REINSURANCE ANALYSIS 1998-A GUY CARPENTER SPECIAL REPORT 32 (Sept. 1998).

[26] Over the period 1990-1997, the growth in cession volume is about 10.5%. But, the growth in direct premium is only about 8%. *See* Swiss Re, *supra* note 17, at 7.

[27] Swiss Re, *supra* note 17, at 5.

[28] For example, reinsurance premium ceded abroad accounted for 45.38% of total direct written premium of the industry in 1996.
See TAIPEI INSURANCE ASSOCIATION, FACT BOOK 1996-NON-LIFE INSURANCE IN

purposes of reinsurance regulation and possible regulatory models currently available from several developed regulations. The first part of Chapter One considers the purposes of reinsurance regulation along with the current global trends of liberalisation of reinsurance and harmonisation of insurance regulation. Taking into account particular market characteristics, the essential purposes of reinsurance regulation for emerging economies will be suggested. The second part of Chapter One then turns to a discussion of the current available models in developed countries as well as the international supervisory principles issued by the Organisation for Economic Cooperation and Development (OECD) and by the International Association of Insurance Supervisors (IAIS). In search for an appropriate regulatory model, it is observed that emerging countries may face a critical balance between the security of reinsurance and the diversification of insurance risk. In addition, it is argued that some developed models might not be appropriate for emerging countries with a shortage of reinsurance. As a result, it is suggested that the regulation of reinsurance arrangements of primary insurers, as well as the assessment of the financial condition of foreign reinsurers should be enhanced.

Based on the above discussion and analysis, the author will use the Taiwanese reinsurance market as a case study for identifying the potential problems in reinsurance regulation in Taiwan, and in emerging economies more generally.

In order to discern an appropriate framework of reinsurance regulation, Chapters Two, Three and Four will consider in more details the specific problems with regard to reinsurers, reinsurance arrangements of insurance, reinsurance intermediaries and alternative risk transfer relating to finite risk reinsurance and securitisation of insurance risk.

Chapter Two mainly deals with the regulation of reinsurers and the regulation of primary insurers' reinsurance arrangements. In terms of regulation of reinsurers, it is difficult to decide upon an appropriate regulatory structure to enable domestic insurers to benefit from the liberalisation of reinsurance without endangering the recoverability of reinsurance. In general, regulation of reinsurers can be categorised into two regulatory approaches: *direct supervision* of reinsurers and *indirect supervision* of reinsurers by way of supervision of reinsurance policies of primary insurers. In terms of direct supervision of reinsurers, all the reinsurers who intend to

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TAIWAN R.O.C., at 14 (1997).

carry on reinsurance business should obtain authorisation or license from the insurance regulators. In such an approach, the reinsurers should meet the regulatory requirements in relation to corporate structure, capital requirements, financial solvency requirements, and the relevant obligation to submit their financial statements.

On the other hand, indirect supervision of reinsurance means that the insurance regulators give emphasis to the reinsurance policies of the primary insurers rather than to the reinsurers. In the case of this indirect regulatory approach, the insurance regulators monitor and supervise reinsurance arrangements of primary insurers. For liberalization of reinsurance business to benefit emerging markets, regulatory reform will be crucial for maintaining the financial solvency of primary insurers. In essence, the financial condition of reinsurers should be the main concern for regulators and primary insurers.

However, the regulators face a dilemma between the strict direct regulation of reinsurers and freedom of reinsurance transactions. In supervising reinsurers directly, regulators can efficiently monitor reinsurers and primary insurers can assess the quality of reinsurance more accurately. In contrast, the direct regulation of reinsurers may have adverse impact on the reinsurance business and may impede the diversification of insurance risks. As an alternative regulatory approach that can ensure the stability of insurance market, it appears that the indirect regulation of reinsurers would be more appropriate for emerging markets to adopt. However, it is argued that the indirect regulatory approach to regulate reinsurers also may have flaws in its character if the following aspects have not been considered. First, as a fundamental and evident precondition, reinsurers should be licensed and subject to meaningful prudential regulation in the respective domiciled countries; the regulatory approach should be based on "mutual recognition", with a similar regulatory regime being considered for the regulation of reinsurers. Second, such a regulatory system should be "harmonized" and based on prevailing internationally accepted prudential regulatory standards. Appropriate governmental supervision of reinsurers is important for reviewing the capital adequacy, solvency and professional competence of reinsurers. An indirect regulation model will be successful only if it is properly structured and takes into account the supervision of foreign reinsurers who already are subject (hopefully) to similar international based regulatory requirements. Third, given that the harmonization of reinsurance regulation would contribute to the stability of global insurance markets and the evaluation of the "security" (*i.e.*, the creditworthiness and financial viability) of reinsurers, the regulatory standards accepted by countries intending to enhance this international regulatory cooperation should not seek the lowest common denominator of regulatory and supervisory standards.

While liberalisation of reinsurance services would benefit the diversification of insurance risks in emerging markets, it is crucial to ensure the security of reinsurance. In the second part of Chapter Two, selective issues relating to primary insurers' reinsurance arrangements will be discussed. The assessment of reinsurers will be first introduced to provide comprehensive criteria concerning the creditworthiness/security of reinsurance. Consequently, the implementation of appropriate regulation concerning the creditworthiness/security of reinsurance will be discussed. As the amount of reinsurance may be used to reduce the required technical provisions (or loss reserves) designed to meet the claims from the policyholders, the regulatory approaches concerning creditworthiness/security of reinsurers generally are considered under the framework of solvency regulation. In addition to the quality and appropriateness of governmental supervision, the quality and appropriateness of corporate governance and internal controls regarding the creditworthiness/security of reinsurance should be considered to ensure the financial solvency of primary insurers. Following upon these discussions, it is argued that the US approach addressing the creditworthiness/security of reinsurers licensed and domiciled abroad might lead to undue restriction on the free movement of international reinsurance transactions. On the other hand, it is suggested that the Mexican approach concerning the reliance of reinsurers on external rating agencies may be more appropriate for emerging markets to maintain the financial stability of primary insurers, although there are some flaws in this approach also.

While international supervisory standards, which have been increasingly developed in recent years, propose to harmonise or to converge reinsurance regulation to establish a "single passport system" throughout the world[29], the major obstacles facing this single license concept will be emphasized. The third part of this Chapter

[29] *See* IAIS-Working Group on Reinsurance, *Reinsurance and Reinsurers: Relevant Issues and Establishing General Supervisory Principles Standard and Practices*, (2000), at 6-7. (last visited

identifies several weakness and major problems relating to this recommendation[30] made by the Reinsurance Subcommittee of the IAIS.

As the insurance regulators and ceding insurers struggle to ensure a critical balance between efficiency of reinsurance and security of reinsurance, the framework of regulation of reinsurance should be properly structured and should take account of particular market characteristics and legal systems. While the shortage of reinsurance is the main issue in emerging markets, insurance regulators should consider an appropriate regulatory approach concerning the security of reinsurance while minimising the adverse burdens caused by the regulation. In this regard, the fourth section of Chapter Two addresses essential aspects for appropriate reinsurance regulation and supervision in emerging markets.

A reinsurance intermediary, also known as a reinsurance broker[31], generally acts as a conduit in the arrangment of reinsurance contracts and as an administrator of the reinsurance contract, claims negotiation and collection[32]. However, these intermediaries do not merely engage in arranging reinsurance for the ceding insurers but also accept or underwrite reinsurance business on behalf of the reinsurers[33]. In emerging markets, these intermediaries may be expected to provide their expertise in relevant insurance law and regulation and to assist domestic insurers in identifying their exposure. Moreover, they may be involved with arranging reciprocal exchanges

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October 20 2001) available at http://www.iaisweb.org.
[30] *Id.*

[31] It has been observed that "At the present time, particularly in reinsurance treaties, brokers are frequently referred to as intermediaries, a name perhaps slightly more elevated than broker." *See* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 333. It also has been argued in England that "the term of intermediary, although it is commonly used in reinsurance, has no legal definition, and in law a broker is an agent." BARLOW LYDE & GILBERT, REINSURANCE PRACTICE AND THE LAW, 2-2 (LLP, Service Issue No. 16-1 April 2000). It should be noted, however, that the term of reinsurance intermediary does not merely include the reinsurance broker who generally is deemed as the agent of insurers, but also include the underwriting agent who acts as the agent of the reinsurers and are known as managing general agents (MGAs) in the United States. As a result, this chapter will not only draw on the regulatory issues arising from the reinsurance brokers but will discuss issues relating to the underwriting agents.

[32] See John S. Diaconis, *Introductory Comments and Basic Overview of Reinsurance Term*, in REINSURANCE LAW & PRACTICE: NEW LEGAL AND BUSINESS DEVELOPMENTS IN A CHANGING GLOBAL ENVIRONMENT 1998, at 25 (Practising Law Institute-Commercial Law and Practice Course Handbook Series, PLI Order No. A4-4548, 778 PLI/COMM 7, October 1998).

[33] R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, supra note 2, at 55. In some cases, the brokers hold a binding authority to assess and assume risk on the behalf of reinsurers.

of reinsurance business[34].

As a result of these functions provided by reinsurance intermediaries, possible risks may arise if these intermediaries are not subject to proper regulation and supervision. Chapter Three considers the reinsurance intermediaries and their influence on financial solvency and stability of insurers. This consideration is made from a comparative analysis of leading regulatory models *vis-à-vis* establishing an appropriate regulatory infrastructure that might be applied in the insurance industry in developing countries such as Taiwan. Section 1 and 2 consider the general duty of reinsurance intermediaries and address the essentiality of regulation of reinsurance intermediaries, as well as the relevant, related regulatory issues. Section 3 then discusses the related experience of several leading regulatory models. The concluding observations in this Chapter suggest a possible regulatory infrastructure for maintaining financial stability of emerging insurance markets in emerging economies.

As the increasing number of alternative risk transfer transactions raise considerable concern for regulators, investors, insurance undertakings and other financial institutions, Chapter Four will discuss two innovative instruments relating to reinsurance regulation- finite risk reinsurance and securitisation of insurance risk.

With regard to finite risk reinsurance, Chapter Four illustrates the nature of finite risk reinsurance and the current regulatory models. Based on a comparative analysis, it is argued that "timing risk" alone is sufficient to constitute a reinsurance contract because the timing risk arising from the uncertainty of liability payment for policyholders will significantly affect the capacity of the ceding insurers. In addition, this Chapter makes several recommendations for development of an appropriate regulatory approach. First, the issue relating to the "economic substance" of transactions should take into account the terms of contracts that may affect the loss payment from the reinsurers and further reinsurance premiums paid by ceding insurers[35]. The criteria regarding the economic substance of a reinsurance contract also should take into account the terms of reinsurance contracts as a whole and should analyse the financial outcome relating to this transaction. Second, the

[34] *Id.* at 56-57.
[35] For instance, experience account, the premium payable estimated by reference to a stated or implied interest rate, a return of profit commission, cancellation or commutation provisions that would result in a loss to the ceding insurers.

creditworthiness/security of reinsurance transactions should be emphasised because these transactions often involve huge amounts of reinsurance premiums and the payments will be distributed over several years[36]. The financial condition of reinsurer will have a significant impact on reinsurance recoveries.

Furthermore, reinsurers who specialise in the area of finite risk reinsurance are often located and registered in less stringent regulated jurisdiction such as Bermuda and the Cayman Islands. This has increased concerns for the security of reinsurance transactions. The regulators should be able to assess the financial viability of the reinsurers.

Third, the adequacy of loss reserves should be considered even though the reinsurance transaction meets the risk transfer criteria. As previously discussed main practical advantage of finite risk reinsurance is the reduction of loss reserves after finite risk reinsurance cover has been provided. As finite risk reinsurance may lead to an inadequacy of loss reserves, it is crucial to develop methods to estimate the extra reserves needed and to analyse the possible effect of the terms of contracts on insurer's financial solvency.

The second part of Chapter Four discusses the securitisation of insurance risks. The basics of securitisation, paying particular attention to the advantages and disadvantages of these transactions, will be identified. This will be followed by a discussion of selective regulatory issues concerning issuance of insurance-linked securities, the structure of special purpose reinsurers and reinsurance contracts. As several countries have developed relevant regulations in that area, the next section will review these models. Finally, a suggestion for the development of a legal infrastructure will be submitted as to the potential problems arising from insurance-linked securities.

In Chapter Five, the Taiwanese insurance market will be followed by a "case study" for identifying the potential problems of and providing the suggestions for developing an appropriate regulatory system relating to reinsurance in emerging market. In this regard, this Chapter will introduce the current Taiwanese insurance regulatory regime and will address Taiwanese recent financial regulatory reform in

[36] For example, under the loss portfolio transfer agreements, the payment of reinsurance recoveries are structured on a financial loss and distributed along with the investment income during the covered period.

this area. With regard to particular market characteristics in Taiwan, the Taiwanese insurance market relies on the international reinsurance market to extend its limited capital capacity to underwrite insurance risks and to stabilize the development of domestic economy. Due to lack of reinsurers in Taiwan, the main issue relating to reinsurance regulation is to establish an appropriate regulatory regime to maintain the financial solvency of primary insurers. It should be noted, however that certain developed regulatory country models might not be appropriate for an emerging market with a shortage of reinsurance. Taking into account the particular regulatory environment and market characteristics, suggestions will be provided for potential solutions for the regulatory reform in the reinsurance sector in Taiwan. A number of recommendation will be developed concerning the introduction of a new framework for the regulation of reinsurance in Taiwan—this, in particular, will draw on the main lessons from countries—U.K., U.S.A., the EU, and other international organisations as well as the operations and development of the main international insurance markets. From this analysis, broader lessons will be drawn as to appropriate reinsurance regulation in emerging markets generally.

Chapter One

Purposes and Structures of Reinsurance Regulation: A Comparative Study

Most of insurance regulations have as their basis a special public interest[1], which is composed of many elements related to different aspects of the underlying insurance

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[1] The insurance regulation could be justified by several theories of regulation, which include the public interest theory, the interest group theory, the private interest theory (economic theory), the institutional theory, and the political theory. Although the public interest theory has generated growing currency for justifying the insurance regulation in recent years, in fact, it is well recognised that the public interest theory has often been used to explain the existence and implementation of insurance regulation.
Firstly, the main theme of the public theory is that regulator acts in pursuit of public rather than private interests. *See generally* C. SUNSTEIN, AFTER THE RIGHTS REVOLUTION: RECONCEIVING THE REGULATORY STATE (Cambridge, Mass., 1990).
Secondly, the interest group theory assumes that regulation is a product of relationships between groups and with the state. *See generally* B. MITCHELL, THE POLITICAL ECONOMY OF REGULATION 100 (New York 1980).
Thirdly, the most important support of the economic theory of regulation, began with an article on " the theory of economic regulation" by George Stigler in 1971, which integrates the analysis of political behavior with the large body of economic analysis. "The major theoretical development of this theory has been an article by Peltzman in 1976 and Gary Becker in 1983." *See* S. Peltzman, *The Economic theory of Regulation after a Decade of Regulation*, BROKKINGS PAPERS ON MICROECONOMICS, 1 Brookings Institution (1989), reprinted in A READER ON REGULATION 93 (Robert Baldwin, ed. Oxford, 1998). *See also* S. Peltzman, *Toward a More General Theory of Regulation*, 119 JOURNAL OF LAW AND ECONOMIC, at 211-240 (August 1976), and Gary Backer, *A Theory of competition among Pressure Groups for Political Influence*, 98 QUARTERLY JOURNAL OF ECONOMICS, at 371-400 (August 1983). Because of its feature that the politicians are presumed to be self-interested maximizers, some articles name the economic theory as private interest theory. *See* A. OGUS, REGULATION: LEGAL FORM AND ECONOMIC THEORY 3-4 (Oxford University Press, 1994). *See also* J. FRANCIS, THE POLITICS OF REGULATION: A COMPARATIVE PERSPECTIVE (Blackwell Publishers 1993); P. L. Joskow, & R.G. Noll, *Regulation in Theory and Practice: An Overview*, in STUDIES IN PUBLIC REGULATION, at 35-40 (G. Fromm ed. 1981).
"Institutionalist Theorists centre on the notion that institutional structure and arrangements, as well as social processes, significantly shape regulation, and that there is more driving regulatory developments than mere aggregations of individuals' preferences. Individual actors are seen by institutionalists as influenced by rules as well as organisational and social settings, rather than as pure rational choice maximizers(unlike private interest theory), and as having preferences that are influenced by institutional procedures, principles, expectations, and norms that are encountered in cultural and historical frame works." R. BALDWIN & MARTIN CAVE, UNDERSTANDING REGULATION: THEORY, STRATEGY AND PRACTICE 27 (Oxford, 1999). *See also* THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS (W. Powell and P. Di Maggio, eds., Chicago 1991); B. LEVY & T. P. SPILLER, REGULATIONS, INSTITUTIONS AND COMMITMENT (Cambridge, 1991).
The main element of the public theory is that regulatory policies are shaped in "the interaction of political institution with in an environment that influences the abilities of these institutions, including the insurance industry, consumers of different kinds, regulatory bureaucrats and political elites, to use their political resources effectively." All of these groups are presumed to be self-interested maximizers. *See generally* K. J. MEIER, THE POLITICAL ECONOMY OF REGULATION-THE CASE OF INSURANCE 27-32 (State University of New York Press, 1988).
Regulatory theory has developed in so many approaches and traditional academic boundaries have been crossed between such disciplines as law, political science, and economics. The concept of public

transaction and of the organisations through which the business of insurance is transacted. Achieving a satisfactory and comprehensive definition of the "public interest" in the regulation of insurance of a country is problematic as it depends on each country's specific market, economic, political and legal circumstances[2]. Nevertheless, the concept of "public interest" in the insurance regulation was expressed early in *German Alliance Ins. Co. v. Lewis*[3] in United States since 1914, and in the official reasons accompanying the proposal for the Insurance Supervision Law in Germany in 1900[4].

Reinsurance is mainly designed to transfer insurer's risk to reinsurers. The primary insurer has to prudently consider in each case "whether reinsurance with the intended reinsurer will result in claims being paid perhaps decades after the risk is placed.[5]" The primary insurer must be careful to disclose all material facts and to consider prudently the contractual terms and conditions. Any breach of contractual duties by a primary insurer may result in a legal dispute or, may enable reinsurers to repudiate liability. Even if all claims are ultimately met in full according to the terms and conditions, a reinsurer in financial difficulties or which is insolvent may not have provided sufficient resource to cover liability of payments[6]. Thus, the stability of the primary insurers would be threatened and so would be the public interests (*e.g.*, insured party, the stockholder of insurance company, and financial system.).

The purpose of this chapter is to discuss the general issues relating to the regulation of reinsurance as to provide a basis for the thematic analysis in the following chapters. To facilitate this task, this chapter is divided into three main

interest is not the single method to justify existing regulation. This volume will not drawn on the arguments of regulatory theories, but will pay more attention on the control of risks caused by reinsurance transactions through regulations.

[2] WERNER PFENNIGSTORF, PUBLIC LAW OF INSURANCE, INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW VOL.6 COMMERCIAL TRANSACTIONS AND INSTITUTIONS CHAPTER 7, 16 (Martinus Nijhoff Publishers, 1996).

[3] *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389(1914).

[4] "...[T]he public interest has an especially large stake in a prosperous and solid development of the insurance business, and imposes on the government a duty of special care in this field." *See* Entwurf eines Gesetzes ueber die privaten Versicherungsunternehmungen: Stenographishe Berishte ueber die Verhandlungen des Reichtstages, X. Legislaturperiode. II. Session, I. Anglageband Nr. 5 (Berlin 1900) at 35, translated by WERNER PFENNIGSTORF, *supra* note 2, at 16.

[5] P. T. O'NEILL, & J. W. WOLONIECKI THE LAW OF REINSURANCE IN ENGLAND AND BERMUDA 160 (1998).

[6] Peter Falush, *The Development Of Reinsurance Markets In The Economies In Transition*, in Insurance Regulation and Supervision in Economies in Transition: Second East-West Conference on Insurance Systems in Economies in Transition, OECD Proceedings, 265 (Organisation for Economic Co-operation and Development 1997).

sections. The first part focuses on analyzing various objectives achieved by regulation of reinsurance and on assessing financial risks caused by reinsurance transactions. The second part identifies the characteristics of reinsurance business that may influence the regulation of reinsurance and discusses the structure of regulation of reinsurance from the existing regulatory models. Learning from several existing regulatory systems, this work, on the third part, will identify selective regulatory problems in Taiwan and will provide some suggestions for possible reform.

I. Purposes of Reinsurance Regulation

The purpose of reinsurance regulation has been described as follows:

"to protect the interest of insureds, claimants, ceding insurers, assuming insurers and the public generally. The legislature hereby declares its intents is to ensure adequate regulation of insurers and reinsurers and adequate protection for those to whom they owe obligations."[7]

This declaration is making a point that reinsurance regulation not only deals with the two parties of the reinsurance contract (the reinsurer and primary insurer), but also intends to provide directly or indirectly adequate protection for insureds, claimants and the public. Following upon this scenario, the purposes of reinsurance regulation can be categorised into two groups: namely, to maintain solvency of insurers and reinsurers who are the reinsurance contracting parties and to protect other external parties affected by the reinsurance operations. In addition, particularly in developing countries, it should be noted that reinsurance regulation is also used as a mechanism to protect local insurance markets and to limit the freedom of operation of reinsurance. In the following sub-section, the implication of these purposes will be introduced and examined.

A. To Maintain Financial Solvency and Solidity of Primary Insurers and Reinsurers

Generally speaking, the regulation of reinsurance mainly deals with the relationship between the solvency of primary insurers and their reinsurance arrangements. Historical evidences also show that several significant insolvency cases have resulted

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[7] NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (N. A. I. C.), *Reinsurance: Credit for Reinsurance Model Law*, in NAIC MODEL LAWS, REGULATIONS AND GUIDELINES VOL.V, 785 (1999).

from uncollectible reinsurance for primary insurers during the 1980s. In this context, insurance solvency regulation can be divided into three parts: technical provision, solvency margin, and control and valuation of assets[8]. With regard to solvency regulation, to what extent reinsurance will affect the solvency of primary insurers depends upon the method of accounting for the technical reserves (which are designed to ensure that an insurer will match all its known liabilities to the policyholders). In general, the methods to account for technical reserves can be classified as on a "gross reserving basis" and on a "net reserving basis". Even in the European Union, member states, who have set up several standards for harmonisation of insurance solvency regulation, still have not been able to agree on the same approach[9].

Some countries on the gross reserving basis do not take reinsurance into account unless reinsurers have deposited premium reserves and outstanding liability reserves with the primary insurers (*e.g.*, in France)[10]. In this case, regulators can monitor the financial condition of insurers without control over their reinsurance arrangements, because the financial security of reinsurance is achieved by the requirement of the deposit of premium reserves and outstanding liability reserves. Under these circumstances, it has been criticized that the stringent deposit requirements will deprive reinsurers of freedom of investment and interest earnings, and will consequently result in added costs that will be passed on to the final

[8] ROBERT KILN & STEPHEN KILN, REINSURANCE IN PRACTICE 383 (4th ed. 2001).

[9] With regard to reinsurance arrangement on technical provision, EC Insurance Directives provides that "If the home Member State allows any technical provisions to be covered by claims against reinsurers, it shall fix the percentage so allowed. In such cases, it may not specify the localisation of the assets representing such claims". It also indicates that every member state can decide which reserving basis it will require. *See* Article 21, Third Non-Life Insurance Directives 92/49/EEC, 1992 O.J. (L.228/1) and article 21 Third Life Insurance Directives, 92/96/EEC, 1992 O.J. (L.360/1). It should be noted that the article 21 of third non-life insurance directive and of third life insurance directive has not been amended by the new Council Directive. *See* Council Directive 2002/12/EEC amending Council Directive 79/267/EEC as regards the solvency margin requirements for life assurance undertakings, OJ 2002, L 77/11; Directive 2002/13/EEC amending Council Directive 73/239/EEC as regards the solvency margin requirements for non-life assurance undertakings, OJ 2002, L 77/17.

[10] "Technical reserves are determined including re-insurance cessions. For European re-insurers, no agreement is required. If is only required for re-insurers, whose head office is situated outside of the European countries" in French Insurance Law article 321.2 and article 321.5., translated by Bertrand Balaresque & Jean-Luc de Boissieu, *Financial Supervision of Insurance Company*, NATIONAL REPORT, in 8th World Congress on Insurance Law, at 223 (AIDA, 1990). Even though technical reserves are determined including reinsurance cession in France, it should be noted that the European Community did not impose any localisation-of-reserves requirements on non-Community reinsurers. See ROBERT L. CARTER & GERARD M. DICKINSON, OBSTACLES TO THE LIBERALIZATION OF TRADE IN INSURANCE, 74 (Thames Essays, Trade Policy research centre 1992).

consumer party[11]. Additionally – with respect to multinational reinsurers - this has engendered not only an adverse effect upon their global financial strength caused by fragmentation of its capital funds but also has increased the strain on their adequate resources to meet urgent claims that might arise anywhere in the world[12]. Thus, this may create an advantage to larger multinational reinsurers who have the ability to transfer adequate capital internationally and efficiently in the international reinsurance markets[13].

Many countries on the net reserving basis permit primary insurers to cover their technical reserves by applicable reinsurance arrangements (*e.g.*, in Germany, United Kingdom, Japan)[14]. On this basis, reinsurance, which can be calculated to cover insurers' technical reserve as admissible assets, becomes an important issue relating to the insurance solvency regulation. This also explains that reinsurance has long been held to be a substitute for capital under the net reserving basis[15]. Under such circumstances, the financial solvency of reinsurers has a direct impact on the ability of primary insurers to fulfill the terms of their insurance contracts. "If regulation allows the primary insurers to cover their reserves by the amount of risk transferred to the reinsurers who are beyond the control of solvency regulation, the requirement of the technical reserve is, to some degree, circumvented."[16] If the reinsurer is insolvent when the time comes to pay the liability on the risk it has ceded from the primary insurer, then the primary insurer's reduced technical reserve may be inadequate as well, resulting in another insolvency or, at least, institutional financial crisis that may impair the primary insurer's future ability to compete in the industry[17].

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[11] The requirement of deposit will increase an reinsurer's extra operating costs, particularly if the regulations extend to reserve funds in excess of expected claims costs, because reinsurers have to acquire and to maintain additional capital to meet this requirement. The extract costs of maintaining capital and the loss of investment will increase the cost of reinsurance arrangements of primary insurers and consequently will tend to be pass on to the final consumer party.

[12] ROBERT KILN & STEPHEN KILN, *supra* note 8, at 389.

[13] *See* ROBERT L. CARTER & GERARD M. DICKINSON, *supra* note 10, at .76.

[14] *See generally* WERNER PFENNIGSTORF, *supra* note 2, at 97-98.

[15] S. M. COUTTS & T. R. H. THOMAS, MODELLING THE IMPACT OF REINSURANCE ON FINANCIAL STRENGTH 4-5 (Institute of Actuaries, London, 24/Feb./1997).

[16] *See* Lee R. Russ & Thomas F. Segalla, COUCH ON INSURANCE, "Part I. The Insurance Industry and Insurance Relationships, Chapter 9. Reinsurance, I. Introduction", § 9:5 (3rd ed., 1995).

[17] *See id.*

Hence regulators should be equally concerned with the financial solvency and financial soundness of the reinsurers as much as primary insurers[18].

B. To Ensure the Interests of Insured Party and the General Public

Insurance regulation often performs two basic functions: it protects against insolvency and regulates market conduct. Solvency regulation is mainly designed to maintain the solvency of insurers and to protect policyholders against "default risk" stemming from financial failure. On the other hand, the purposes of market conduct regulations are to ensure the fairness, equity and reasonableness in insurance transactions. Reinsurers, as insurers, are regulated for financial supervisory purposes, but, with few exceptions, basically are not regulated by market conduct regulation relating to contract on terms, conditions and tariff.

Financial supervision of primary insurers is concerned mainly with the insurers' ability to meet their contractual obligations. Apart from the interests of the insured party, an insurer's financial solvency is the primary concern for capital market investors generally. These various groups have different concerns depending on their own particular interests[19]. The regulation of reinsurance has the same purpose as other financial supervisions. Not only does this form of regulation intend to maintain financial soundness of primary insurers and reinsurers, but also it is intended to provide adequate protection for policyholders, investors and the public in general.

On the other hand, market regulation is designed to protect the insured party, and is generally inappropriate in the context of the regulation of reinsurance. The reinsurance contracting parties are presumed to be sophisticated participants, knowledgeable in insurance matters and capable of protecting their interests[20]. In addition, the flexibility of reinsurance contracts on terms, conditions and tariff is a key characteristic of reinsurance transactions. For these reasons, reinsurance transactions have been excluded from most regulatory systems regulating the relationship between the insured party and the primary insurers[21]. Due to the complexity and diversity of reinsurance transactions, however, reinsurance terms and

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[18] *See* Charles W. Havens III and Rita M. Theisen, *The Application of United States and EEC Antitrust Laws to Reinsurance and Insurance Pooling Arrangement*, Developments-1985-Antitrust and the Business of Insurance, 54 ANTITRUST LAW JOURNAL 1299, 1303 (American Bar Association, 1986).

[19] WERNER PFENNIGSTORF, *supra* note 2, at.84.

[20] *See* Charles W. Havens III and Rita M. Theisen, *supra* note 18, at 1303.

conditions may have a direct effect on the interests of policyholders and investors in some cases. This has gained attention by some regulators, beginning with the case of *Fidelity and Deposit Company v. Pink*[22] in the United States since 1937. For example, in the United States, a reinsurance agreement must contain a provision, the "solvency clause", stating that "in the event of the insolvency of the primary insurer, the reinsurers shall pay reinsurance proceeds to the domiciliary liquidator based on the liability of the ceding insurers, regardless of whether the liquidator can fully pay such liability"[23]. Without such a clause, a U. S. primary insurer would not be able to take credit for the reinsurance to reduce the technical reserve in its statutory financial statements. The purpose of this requirement is to ensure that the reinsurance is payable directly to the company or its liquidator without reduction in the event of the insolvency of the primary insurer.

C. To Protect the Local Insurance and Reinsurance Market

It is widely accepted that the object of reinsurance is to spread risk domestically or even internationally and the necessity for reinsurance stems from the financial imperative for large exposures[24], both as to single risks or catastrophic accumulations[25]. Therefore, reinsurance transactions are subject to less stringent

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[21] *See id.* at 1303-1304.

[22] 302 U. S. 224 reh'g denied, 302 U. S. 780 (1937). In this case, following the primary insurer's insolvency, "the superintendent of Insurance of New York, Pink, demanded that the reinsurer pay half of the primary insurer's obligations under the reinsurance contract. Before the U.S. Supreme Court, the reinsurer contended that the reinsurance contract was one of indemnity that required the reinsurer to reimburse the liquidator only with respect to that proportion of losses the liquidator actually paid to claimants. The liquidator contended that it should be reimbursed for the primary insurer's liability to claimants, regardless of the amount the insolvent company was able to pay them. Based on the language of the reinsurance agreement, which the Court found made payment of a claim a condition precedent to reinsurance recovery, the United States Supreme Court found for the reinsurer." *See* ROBERT W. HAMMESFAHR & SCOTT W. WRIGHT, THE LAW OF REINSURANCE CLAIMS 252 (Reactions Publishing Group, 1994). *See also* M. J. Laughlin, *General Clause for Most Treaties*, in REINSURANCE CONTRACT WORDING 98-99 (Robert Strain ed., 1992).

[23] *See* ROBERT W. HAMMESFAHR & SCOTT W. WRIGHT, *supra* note 22, at 252.

[24] The need for spreading risk internationally is well recognised by governments in both developed and developing countries and by international agencies such as the United Nations Conference on Trade and Development (UNCTAD). See ROBERT L. CARTER & GERARD M. DICKINSON, *supra* note 10, at 5.

[25] It has been addressed that the benefits of recourse to international reinsurance so are self-evident for: "(1)large risks where a single loss may account for a substantial proportion of (and in case of some small developing countries, more than) the total premium income of all domestic insurers; (2) catastrophe risk, notably where a country is so exposed to natural perils that a single event may destroy a significant part of its productive and other resources." *See* R. L. CARTER, L. D. LUCAS, N. RALPH, REINSURANCE 861 (Reactions Publishing Group, 4th ed., 2000).

regulations than those applied to direct insurance transactions in most countries[26]. On the other hand, national interests largely have been concerned with the protection of the local insurance and its domestic reinsurance market. To facilitate this concern, particularly in developing countries, reinsurance regulation has been used as a mechanism to build up a local reinsurance market by protecting domestic insurers from foreign competition, to avoid unnecessary loss of foreign exchange through the purchase of reinsurance from abroad[27], and to reduce the country's dependence on the supply of foreign reinsurance[28].

1. Building Up the Local Reinsurance Market

The need to protect and to build up the local market is argued usually from two conflicting points of view. Local control would deny the efficient competition and assimilation of the risk concentration. It is well recognised that a compulsory state-owned reinsurance company would result in inflexible and inefficient reinsurance coverage being provided to the local insurers[29]. In addition, on the basis of the law of the large numbers[30], these stringent protections will reduce the risk reduction advantages obtained from writing a geographically well-diversified reinsurance portfolio[31].

On the other hand, from the viewpoint of local protectionism, the newly established local reinsurers should be protected from the competition of multinational reinsurers which enjoy the benefits of scale from their extensive worldwide operations

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[26] ROBERT KILN & STEPHEN KILN, *supra* note 8, at 394-395. In addition, there are three reasons to explain why trade in reinsurance is subject to less regulation than trade in direct insurance. Firstly, domestic insurance market can gain access to the capital and technical expertise of the international insurance market because of the existence of well-developed reinsurance market. Secondly, the fiduciary concern of the regulatory authorities is less than for direct insurance, for insurance companies can be assumed to be better-informed consumers than the general public. Thirdly, the greater use of a reinsurance is considered to afford the balance-of –payments savings over trade in direct insurance. See ROBERT L. CARTER & GERARD M. DICKINSON, *supra* note 10, at 5.

[27] "Reinsurance placed with insurers located abroad will over time lead to an outflow of premium payments which will be only partly offset by claim inflows. Even if funds required to cover expected claims and local expense are maintained in the country, contributions to central reserves and profits will be remitted abroad." Even though foreign reinsurers are established within the country, profits earned will through time be remitted to the parent head office. In additional, local reinsurers may also transfer their risks to their parent. See ROBERT L. CARTER & GERARD M. DICKINSON, *supra* note 10, at 33-34.

[28] *See id.* at 28-29.

[29] ROBERT KILN & STEPHEN KILN, *supra* note 8, at 393.

[30] "If an insurance company can combine in one account a large number of similar units, independently exposed to loss, then there will be a tendency for the variation in the size of the total losses which it may incur during any one year to be smaller, relative to the amount of business transacted." See ROBERT L. CARTER & GERARD M. DICKINSON, *supra* note 10, at 14-15.

and which have adequate capital and expertise to withstand competition. It is also argued that a high density of reinsurers operating in a market leads to wasteful and destructive competition[32] because of the danger of intensive competition undermining a reinsurer's solvency and thus the security provided for primary insurers[33]. Moreover, it is equally unacceptable that the world's reinsurance industry is concentrated among a hand of few giant multinational reinsurers[34] if developing countries fail to build up their domestic reinsurers[35].

2. Balance of Payments and Shortages of Foreign-Currency Holdings

The reinsurance of local risks with foreign reinsurers may affect a country's balance of payments and may tend to impact adversely on a country's foreign-currency holdings. Balance-of-payments considerations, particularly in developing countries, have been a major economic motive behind the establishment of reinsurance regulation. This, more probably, will lead over times, to an outflow of premium payments, which will be only partly offset by claims inflows[36]. "While countries will be influenced by their own international competitive position in assessing balance-of-payments consideration, the issue is inevitably bound up with the nature of the existing international monetary system and the general level of confidence in this system.[37]" The actual strain on a country's balance of payment, however, will be reduced by several factors over the long-term. Balance of payments costs are often

[31] *See id.* at 74.

[32] In some cases, a large foreign insurer may enter the domestic market and adopt a strategy of offering unsustainable low price to acquire market share. This may lead to destructive competition that can reduce the financial strength of smaller local companies and may cause insolvencies. *See* Gerry Dickinson, *The Changing Focus On Insurance Regulation*, in 15th International Progress Seminar on: Regulation in Financial Services: Implication for Services 2000 Vol.1, at 65, The Geneva Association (Geneva 16-17 September 1999). *See also* ROBERT L. CARTER & GERARD M. DICKINSON, *supra* note 10, at 33.

[33] See ROBERT L. CARTER & GERARD M. DICKINSON, *supra* note 10, at 31-33.

[34] Several dominant global reinsurance group-Munich Re, Swiss Re, General Re, and Employers Re, wrote more than one-third of world wide reinsurance business, and the twenty-five largest reinsurers accounted for nearly two-thirds in 1998 and the first half of 1999, *See* Alan Murray, *Global Reinsurance-Industry Outlook*, Global Credit Research, at 7, Moody's Investors Service (New York, 1999).

[35] ROBERT KILN & STEPHEN KILN, *supra* note 8, at 393.

[36] "Even if funds required to cover expected claims and local expenses are maintained in the country, contributions to central reserves and profits will be remitted abroad." See ROBERT L. CARTER & GERARD M. DICKINSON, *supra* note 10, at 33-34.

[37] See ROBERT L. CARTER & GERARD M. DICKINSON, *supra* note 10, at 84-85.

reduced by claim payment, investment gains[38], reinsurance commissions[39], and other service costs paid to local consumers. "Thus the overall balance-of-payment costs of reinsurance imports are substantially less than any superficial examination of the outflow of premium payment would suggest."[40] Even so, the net outflow of balance-of-payments may be a reasonable extra price to pay for security provided by international reinsurance without endangering any one company or the economy of any one country[41].

3. National Security Concerns

With regard to the interests of national security, some countries may build up their domestic reinsurance industries to prevent from the threat of a high dependence upon reinsurance imports. In this regard, tow examples have been cited[42]: the Arab region's commercial vulnerability to the decisions of the London marine insurance market and suspension of marine and aviation cover on Argentine ships, aircraft and cargo during the Falkland Islands conflict. It should be noted, however, that the decision of building up domestic reinsurers in the interests of national security is *de factor* mainly based more on political rather than economic concerns[43].

D. The Trend of Liberalisation, Harmonisation, and Consolidation on Reinsurance Regulatory System and Global Market

While in the past several decades many developing countries have established state-owned reinsurers to meet their own reinsurance demands, their reliance on foreign reinsurance is still high. It has been observed that "the small size of the markets, the imbalance nature of the insurance portfolios and certainly the lack of sufficient

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[38] Investment funds obtained from the prepayment of reinsurance premium are often retained in the country of operation. The earning of the investment will reduce the potential balance-of-payments cost of external reinsurance.
[39] The purpose of reinsurance commission is to compensate primary insurers' acquisition costs and additional administrative costs.
[40] See ROBERT L. CARTER & GERARD M. DICKINSON, *supra* note 10, at 86. It should be noted that in 1989, 1990, 1992 the huge American Insurance Industry received more from reinsurers located in Western Europe by way of claims payments than they paid to them in premiums. *See* R. L. CARTER, L. D. LUCAS, N. RALPH, *supra* note 25 at 873.
[41] *See* R. L. CARTER, L. D. LUCAS, N. RALPH, *supra* note 25 at 873. *See also* H. von Urbanski, *Reinsurance: Legend and Reality*, in DIE INDUSTRIE, (July 1977), *reprinted in* THE REVIEW, (26/Aug/1977).
[42] *See* Harold D. Skipper, *Protectionism in the Provision of International Insurance Service*, JORUNAL OF RISK AND INSURANCE, Vol. LIV, No. 1 (1987).
[43] See ROBERT L. CARTER & GERARD M. DICKINSON, *supra* note 10, at 36.

experience and know-how" are among the main reasons for this situation[44]. Furthermore, the trend of deregulation of primary insurers and liberalisation of reinsurance operations, particularly in the developing countries, has had a significant impact on these developing domestic markets previously protected from foreign competition. Multinational negotiations between different countries and international organisations have been set up to liberalise the insurance and reinsurance transactions under the auspices of the Organization for Economic Cooperation and Development[45] (OECD) and the General Agreement of Trade in Service/World Trade Organization (GATS/WTO)[46]. Under these external multilateral negotiations, efforts have been undertaken to remove the barriers to trade in reinsurance[47].

At the same time, with increasing international penetration into the domestic insurance markets and increasing cooperation to remove trade barrier among different countries, the harmonisation of insurance regulation has become an important issue to resolve the conflicts among different jurisdictions[48]. As a matter of fact, international

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[44] J. FRANçOIS OUTREVILLE, REINSURANCE IN DEVELOPING COUNTRIES-MARKET STRUCTURE AND COMPARATIVE ADVANTAGE, United Nations Office at Geneva, United Nations Conference on Trade and Development, Discussion Papers No.121, at 12(Geneva, Oct./1996).

[45] The organisation for Economic Cooperation and Development (OECD) with a current membership of 30 countries accounting for about 90% of world insurance premiums has contributed to remove barrier to trade in insurance. "The aim for liberalisation is being pursued in close co-operation with the Committee on Capital Movements and Invisible Transactions, which is the "watch dog" for the two OECD Liberalisation Codes: the Code of Liberalisation of Current Invisible Operations and the Code of Liberalisation of Capital Movements". *See* OECD, *Liberalisation of Insurance Markets and International Co-operation*, (last visited 25/02/2000) available at http://www.oecd.org//daf/financial-affairs/insurance/liberalisation.htm

[46] According as the conclusion of the Uruguay Round of Multilateral Trade Negotiations, the World Trade Organisation was created on 1 January 1995. *See* WORLD TRADE ORGANISATION (WTO), FINAL ACT EMBODYING THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS (1994). The General Agreement on Trade in Service is specified in the Annex 1B of the WTO Agreement. Under GATS/WTO, two provisions have a substantial effect on the reinsurance activities, namely Annex on Financial Service and Understanding on Commitments in Financial Service. In the Annex on Financial Service, a member must not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policyholders, or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. See WTO, ANNEX ON FINANCIAL SERVICES, para. 2 (a).

[47] Under *Twenty Guidelines for Insurance Regulation and Supervision in the Economies in Transition*, which was a major outcome of the second East/West Conference on insurance systems in economies in transition organised by the OECD Insurance Committee in co-operation with the Polish government held in 1997, OECD strongly encourages its member countries to liberalise cross-border operations related to reinsurance and dismantling the restriction on the access to international reinsurance market. *See* OECD, *Presentation on the Second East/West Conference on Insurance Systems in Economies in Transition* (15/04/1999), available at http://www.oecd.org//sge/ccnm/pubs/cpge1112/Pres.htm (visiting time: 25/02/2000).

[48] Differences in regulation between countries may result in "regulatory diversity" which "can impede the continued internationalisation of financial service by (1) magnifying the negative effects of market failures, (2) provoking more stringent domestic trade-related regulation, and (3) increasing transactional costs." *See generally* Harold. D. Skipper Jr., *Regulatory Harmonization and Mutual*

cooperation among different countries is having a tendency to develop more formal structures and to provide international supervisory principles on a regional basis and at a worldwide level[49]. Following these trends of liberalisation of trade in reinsurance and harmonisation of reinsurance regulation makes it difficult for a country to reconcile these conflicting regulatory purposes and with choosing the regulatory systems to achieve this end. In addition, while the purpose of reinsurance regulation has been gradually shifted from local protectionism to liberalisation of reinsurance operations, the trends toward consolidation in global reinsurance and increased competition are having a significant impact on the international reinsurance markets[50]. Related insurance/reinsurance institutions mergers not only have become increasingly international but also include other financial sectors e.g., Citigroup and Travellers in the US, Commercial Union and General Accident in the UK, and AXA and UAP in France[51]. With the increasing consolidation in international reinsurance, it is reasonable to assume that more official attention might be paid to competition policy and anti-competitive activities relating to mergers and arrangements among reinsurers[52].

E. Interim summation

The purposes of reinsurance regulation are intended not only to maintain financial solvency and the solvency of primary insurers and reinsurers but also to provide adequate protection for the interests of insured party, claimants, investors and the general public. On the other hand, particularly in developing countries, reinsurance regulation has been used as a mechanism to preserve national interests concerned with the protection of local reinsurance and insurance markets.

Recognition In Insurance, in INTERNATIONAL RISK AND INSURANCE: AN ENVIRONMENTAL-MANAGERIAL APPROACH, at Chapter 14 (Harold. D. Skipper Jr., ed., Boston, Irwin McGraw-Hill, 1998).

49 Apart from European Union, there are numerous activities among different areas to develop formal structure and regular meetings. For example, Confèrence International des Contrôles d'Assurances des Ètats Africains (CICA) is formed by twelve French-speaking countries of western Africa. There also has been a tradition of regular meetings and close cooperation among the insurance regulators of South-east Asia and those of the Caribbean. *See* WERNER PFENNIGSTORF, *supra* note 2, at 40-41.

50 *See* Alan Murray, *supra* note 34, at 7-8 (New York, 1999).

51 *See* OECD, *Competition and Related Regulation Issues in the Insurance Industry*, (1998) (3 March 2000), available at http:// www.oecd.org/daf/clp.

52 These trends can give rise to conflict between sector-specific regulators and the competition authority. *See generally* OECD, *Competition and Related Regulation Issues in the Insurance Industry*, (1998), available at http:// www.oecd.org/daf/clp. Visiting time: 11:48, 03/03/2000.

Due to the trend toward greater liberalisation of reinsurance operations, however, trade barriers are being gradually dismantled by the efforts undertaken by many international negotiations and organisations. Thus, the purpose of reinsurance regulation related to preserving national interests is becoming less emphasized today, the same degree as before. So such, following this trend, it is difficult for many regulators to reconcile or to compromise the conflicts between regulation in the interests of consumers, claimants, investors and regulation as a necessary barrier to preserve national interests including national economic, currency and security interest[53].

On the other hand, it has been observed that "financial liberalisation makes attacks possible and expose underlying vulnerabilities to the vagaries of international capital markets: this tension between market liberalisation and system stability and safety and soundness needs to be better understood and appreciated by all.[54]" As insurance regulation is being gradually built on a set of pro-competitive principles designed to ensure competitive, solvent and fair market[55], so also the reinsurance markets seem to be becoming more competitive than before. Thus, particularly in emerging markets, it is important to establish an adequate prudential regulatory system for the insurance supervisor to deal with more complicated and difficult issues and to prevent an improper sequencing of liberalisation. To establish a prudential regulatory system in the reinsurance sector, governments should enact and should enforce laws and regulations that provide an effective framework for competitive reinsurance markets[56] and should establish reasonable solvency regulations as the primary means of protecting the general public[57].

II. The Structure of Reinsurance Regulation

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[53] It is also "difficult to establish a clear distinction between regulation in the interest of consumers or as a necessary means to preserve the national economy or currency on the one hand and discriminatory favouritism on the others." *See* WERNER PFENNIGSTORF, *supra* note 2, at 41.

[54] JOSEPH J. NORTON, FINANCIAL SECTOR LAW REFORM IN EMERGING ECONOMIES 10 (London, 2000).

[55] *See* Harold D. Skipper, Jr., *The Impossibility of Separating Domestic Regulation In Insurance From International Trade Issues*, in 231 ETUDES ET DOSSIERS REGULATION IN FINANCIAL SERVICES: IMPLICATIONS FORSERVICES, at 199 (The Geneva Association, Geneva, 1999).

[56] As markets move from restrictive to liberal regulatory approach, "competition law becomes more important as some firms will have motives to try to engage in anti-competitive practices." Competition law is a crucial component of the framework that could promote the competitive markets. *See* Harold D. Skipper, Jr., *supra* note 55, at 200.

[57] *See id*, at 201.

Due to the unique characteristics of the reinsurance business, however, the regulation of reinsurers differs in many respects from that of primary insurers. These characteristics not only lead to a regulatory environment in which reinsurers are not regulated to the same degree as primary insurers in most countries[58], but also result in the difficulties of implementation of regulation of reinsurance particularly as to the international nature of reinsurance markets. The contracting parties in reinsurance transactions are considered to be sophisticate participants capable of expertise on the insurance business. Thus, in this sector, the level of regulation has been reduced or even completely exempted in most countries[59]. In addition, reinsurance transactions are based on cross-border operations in order to spread risk more effectively. Primary insurers often transfer their risk to the reinsurers which are supervised by different regulatory system. Following such a scenario, reinsurance regulation "not only would be difficult to enforce but if enforced vigorously could have an adverse effect on the availability of coverage for domestic risks and the spread of risks on an international level."[60].

A. The General Structure of Reinsurance Regulation

In general, the regulation of reinsurance can be divided into two aspects; i.e. the supervision (1). of the reinsurance arrangements of primary insurers(*indirect reinsurance regulation*) and (2). of reinsurers and of direct insurers that accept reinsurance business[61](*direct reinsurance regulation*). The structure of reinsurance regulations in each country "concerns the extent to which regulators can rely on (1) on the financial soundness and integrity of reinsurers, and (2) on the ceding insurer's liability and willingness to select reliable reinsurers."[62] In addition, while emerging markets may be influenced by their own international competitive position in assessing balance-of-payments considerations, the structure of reinsurance regulation is inevitably bound up with the protection of the local currency and economy. Thus,

[58] *See* R. C. L. Bakker and H. J. M. Teeuwen, *The IAIS Survey On Reinsurance Supervision: An Overview Of The Finding*, 23 THE GENEVA PAPERS ON RISK AND INSURANCE, No. 89 (Oct/1998).
[59] *See* WERNER PFENNIGSTORF, *supra* note 2, at 43.
[60] *Id*, at 43.
[61] Peter Falush, *supra* note 6, at 265.
[62] *See* WERNER PFENNIGSTORF, *supra* note 2, at 97.

the structure of reinsurance regulations depends *inter alia* on the particular market structure, regulatory environment, business usage and experience of each country[63].

The main concern relating to supervision of reinsurance arrangements of primary insurers is how to assess the reliability of reinsurers. The supervision of the reinsurance arrangements of primary insurers can be regulated in the following respects. Firstly, in most countries, insurance laws and regulations require a primary insurer to reinsure the mandated percentage of risk in order to reduce its underwriting risk. In many cases, the risk retention is required to be a fixed minimum percentage by insurance supervisors[64]. Secondly, the reinsurance programmes and contracts would be reviewed and monitored by insurance supervisors on a case-by-case basis and would need prior approval of the regulators in their first several years. The supervisor frequently requires prior approval of reinsurance contracts "put into place at the time of licensing and must usually be informed of any changes in an insurer's reinsurance programmes and may or may not require prior approval of such changes"[65]. In addition, the security of reinsurance is the main concern among primary insurers and insurance supervisors for the reason that unrecoverable reinsurance have resulted in several major insolvencies during the 1980s[66]. As a result, the choice of reinsurers in primary insurer's reinsurance programmes are regulated or supervised by regulators in some developed regulatory systems. In this case, regulations often differentiate between reinsurance transferred to reinsurers authorised by the domestic insurance regulators and that transferred to unauthorised reinsurers established in some other countries[67]. In emerging markets, it should be noted that some governments establish stated-owned reinsurance corporations to protect their reinsurance and insurance markets and to meet their domestic demand on reinsurance. In this case, regulations or statutes may require domestic primary insurers to reinsure a specified portion of their risk to state or nationally owned

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[63] *Id,* at 97.

[64] According to the survey by OECD in 1996, "the risk retention (of net non-life premiums as a percentage of gross premiums) is required to be a minimum 10% by Swiss supervisors and in Canada the minimum retention ratio is 25% if reinsurers are local and 75% if foreign." *See* Peter Falush, *supra* note 6, at 285.

[65] UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, SUPERVISION OF INSURANCE OPERATIONS-A MANUAL FOR TRAINEE STAFF OF INSURANCE SUPERVISORY AUTHORITIES, Module Three, at 14-15 (1996).

[66] *See* MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON & PETER R. KENSICKI, PRINCIPLES OF REINSURANCE VOL.2, at 193 (Insurance Institute of America, Pennsylvania, 2nd edition, 1995).

reinsurance corporations[68]. Through such control, the government not only would influence reinsurance transactions on contract terms and the premium rates, but also would facilitate its protection on the national currency[69].

With regard to direct reinsurance regulation, many jurisdictions may require that reinsurers be licensed to the same degree as primary insurers. Although the characteristics of reinsurance operations differ from that of insurance contracts and result in a regulatory environment under which individual reinsurance transactions have been completely or partially excluded from market regulations, stringent solvency regulations still play a crucial role under reinsurance regulations.

B. International Supervisory Standard Convergence and its Influence on Reinsurance Regulation in Emerging Markets

On the international level, with regard to reinsurance regulation, international supervisory standards have been established by several international organizations such as the Organization for Economic Cooperation and Development and the International Association of Insurance Supervisors.

According to the twenty insurance "guidelines" for insurance regulation and supervision approved by twenty-one OECD countries and seventeen countries in Central Eastern Europe and the New Independent States, several fundamental principles relating to reinsurance regulation have been established. The main purpose of these guidelines is not only to liberalise reinsurance transactions on cross-border operations[70] but also is to strengthen international co-operation relating to information exchange[71] in order to facilitate the monitoring of the activities of reinsurers and to

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[67] *See* WERNER PFENNIGSTORF, *supra* note 2, at 98.

[68] United Nations Conference on Trade and Development, *Supervision of Insurance Operations-A manual for trainee staff of insurance supervisory authorities*, (1996), at Module Three p. 15-16. *See also* J. FRANÇOIS OUTREVILLE, supra note 44, at 12.

[69] *See* WERNER PFENNIGSTORF, *supra* note 2, at 135.

[70] Rule no.4: Establishment of foreign insurance companies should be based on prudential but not on discriminatory rules. Liberalisation of cross-border operations, at least concerning reinsurance and international risks, should be encouraged. *See* OECD, *Twenty Insurance Guidelines For Economies In Transactions*, in OECD News Release, (Paris, 17/April/1997), available at http://www.oecd.org/search97cgi/s97_cgi (visiting time: 04/01/99)

[71] Rule no. 14: Regulation should not restrict free access to international reinsurance markets. Compulsory cessions of risks to domestic/national reinsurers should therefore be avoided. The collection and monitoring of information relating to reinsurance companies should be established. International co-operation is particularly important to obtain accurate information and should be strengthened. *Id.*

promote the development of sound, modern and open insurance markets[72]. Under the principle of liberalisation of reinsurance operations, reinsurance regulations adversely affecting free access to international reinsurance market should be avoided. Thus, the barriers of compulsory cessions of risks to domestic/state-owned reinsurers should be dismantled. On the other hand, the alternative regulatory system to safeguard the financial soundness of primary insurers should be established and implemented. With regard to the alternative regulatory system, however, these guidelines only propose that governments should strengthen co-operation on information exchange in order to facilitate the monitoring of the activities of reinsurance companies. Despite the lack of substantial supervisory arrangements in these guidelines, they encourage the general structure of mutual recognition among the member countries and have been influential in shaping supervisory practices in the international context.

The IAIS established in 1992 is committed to developing standards for insurance supervision throughout the world[73] and to monitoring adherence to those standards by insurance supervisors within their jurisdictions. It has issued, and continues to develop, principles, standards and guidance papers for insurance supervisors. With respect to reinsurance regulation, the IAIS has established basic principles to regulate and to supervise reinsurance operation. According to the principles, supervisors have to ensure their ability to review reinsurance arrangements, to assess the degree of reliance placed on these arrangements and to determine the appropriateness of such reliance. Moreover, in order to determine the appropriateness of reliance placed on these arrangements, the following requirements should be established and enhanced by an insurance supervisor:

--"The amount of the credit taken for reinsurance ceded. The amount of credit taken should reflect an assessment of the ultimate collectability of the reinsurance

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[72] Rule No. 19 Governments should strengthen co-operation in order to exchange information on insurance regulation and supervision, facilitate the monitoring of the activities of foreign insurance and reinsurance companies and promote the development of sound, modern and open insurance markets. *Id.*

[73] "Its membership includes insurance regulators and supervisors from more than 100 jurisdictions, who resolve to; (1) co-operate to ensure improved supervision of the insurance industry on a domestic, as well as on an international, level in order to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders; and (2) unite their efforts to develop practical standards that members may choose to apply." *See* INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS (IAIS), INSURANCE PRINCIPLES, STANDARDS AND GUIDANCE PAPERS 1 (Basel, December 1999).

recoverables and may take into account the supervisory control over the reinsurers; and

--The amount of reliance placed on the insurance supervisor of the reinsurance business of a company which is incorporated in another jurisdiction"[74].

With respect to the amount of the credit taken for reinsurance ceded, it should depend on the collectability of the reinsurance recoverables which can be assessed and may take into account the supervisory control over the reinsurers. In other words, an insurance supervisor should assess the collectability of the reinsurance recoverables to compute the amount of the applicable reinsurance, which can take the credit to cover the technical reserve, on the net reserve basis. In addition, the assessment of the collectability of the reinsurance recoverables may take into account the supervisory control over the reinsurers for the reason that reinsurance transactions often operate on a cross-border basis.

Due to the cross-border characteristic of reinsurance transactions, reinsurers often operate in another jurisdiction. In order to obtain accurate information to establish the method for collection and monitoring of information relating to reinsurers, it is essential for an insurance supervisor to enhance international cooperation as to information exchange relating to regulation and supervision[75].

From the viewpoint of local protectionism, particularly in emerging markets, governments may impose reinsurance regulations which have restrictive effects on reinsurance transactions between local primary insurers and foreign reinsurers. Domestic insurers may be required to reinsure their risk with a domestic or state-owned reinsurance corporation. In many emerging markets, insurers are obliged to cede to the local reinsurance corporation a specified share of all business written. In some cases, insurers must place their reinsurance with local state-owned reinsurance corporation which alone is permitted to retrocede risks abroad. In addition, primary insurers may be required to place all or part of certain classes of insurance with a local or regional pool[76] which is a group of domestic-established insurers or reinsurers each of whom agrees to assume a predetermined share of all the insurance business written

[74] *See* INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, *supra* note 73, at 7.
[75] *See* INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, *supra* note 73, at 83.
[76] See ROBERT L. CARTER & GERARD M. DICKINSON, *supra* note 10, at 43.

by the members of the pool[77]. These requirements should be deemed as an unnecessary barriers to international trade in reinsurance service.

On the other hand, regulations and accounting rules may have indirect effects on the reinsurance transactions operating on a cross-border basis. In some cases, primary insurer can not be permitted to take credit for the amount of reinsurance placed abroad with foreign reinsurers established in other country on a net reserving basis, unless reinsurers either deposit with their share of the unearned premium and outstanding claims reserves or deposit funds with the supervisory authority to obtain "approved reinsurer status[78]". Reinsurance regulations which may have an indirect effect on the placing of risk with foreign reinsurers, however, not only often exits in emerging markets but also are imposed in some developed countries (*e.g.*, in the United States)[79]. It is difficult to establish a clear distinction to define such a regulation as either a prudent regulation in the interests of general public or a discriminating measure against foreign reinsurers.

C. Developed Models of Structure of Reinsurance Regulation

The differing regulatory approaches in the United Kingdom, within the European Union and in the United States to reinsurance activities are worth examining. In the following context, legislation and regulation in these developed models will be addressed respectively.

1. European Union and United Kingdom

a. Regulation of Reinsurers in the European Union and the United Kingdom

The reinsurance markets in the European Union have become highly internationalised and less heavily regulated than the direct insurance business[80]. As a result, introducing "the right to freedom of establishment" within in the EC/EU was rather straight forward in the case of reinsurance operations while the first tentative EC moves towards "the single market" were taken[81] in the so-called reinsurance directive on the

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[77] *See* Charles W. Havens III and Rita M. Theisen, *supra* note 18, at 1301.
[78] Peter Falush, *supra* note 6, at 266.
[79] For details, *see* NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (N. A. I. C.), *Reinsurance: Credit for Reinsurance Model Law*, in NAIC MODEL LAWS, REGULATIONS AND GUIDELINES VOL.V, 785-1(1999).
[80] *See* ROBERT MERKIN & ANGUS RODGER, EC INSURANCE LAW 4 (Longman 1997).
[81] *Id*, at 4.

freedom of establishment and service (1964)[82]. The adoption of the First Insurance Directive[83] on freedom of establishment and freedom to provide reinsurance and retrocession services abolished all restrictions on establishment and provision of service relating to reinsurance[84]. Reinsurers established in the European Union, therefore, have not only the right to freedom of establishment, but also the legal right to supply their service across national EU country borders, in both cases subject to their complying with the host's domestic rules applicable to reinsurers[85]. When the EC solvency margins were first introduced in implementing the Co-insurance Directive of 1978[86], however, reinsurers who only carried on reinsurance business were excluded from the new requirements. Consequently, it should be noted that reinsurance is not covered[87] by the third generation of EU Insurance Directives[88] developed to complete the progress toward a "Single European Insurance Market". As a result, the regulation of reinsurers differs from those applied to insurers underwriting direct insurance business or direct and reinsurance business[89]. In other words, professional or pure reinsurers having an authorisation restricted to reinsurance do not benefit from the single license system developed in the "third generation" of Insurance Directives. The regulation of reinsurers in the European Union thus has not been harmonised and varies in every EU member state.

Before the implementation of the UK Financial Services and Markets Act 2000 (2000 c8, FSMA 2000), the main legislative provisions which governed insurance companies in the United Kingdom were the Insurance Companies Act 1982 (1982 c50, ICA1982) and the Insurance Companies Regulations 1994 (SI 1994/1516).

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[82] It was published in O. J. No. 56 of 4/4/1964 and is reproduced in Part IX, Appendix B post. *See* T. HENRY ELLIS, THE SINGLE EUROPEAN MARKET AND INSURNACE LAW & PRACTICE 65 (Witherby, London, 1994).

[83] COUNCIL DIRECTIVE ON THE ABOLITIONS OF FREEDOM OF ESTABLISHMENT TO PROVIDE SERVICES IN RESPECT OF REINSURANCE AND RETROCESSION, 64/225/EEC, 1964 O.J. L 56, 3.4.64, p.878(s. edn 1963-64, p.131) special edition.

[84] CLIFFORD CHANCE, INSURANCE REGULATION IN EUROPEAN 12 (LLP, London, 1993).

[85] *See* ROBERT MERKIN & ANGUS RODGER, *supra* note 80, at 4.

[86] COUNCIL DIRECTIVE 78/473 of 30 May 1978 on the co-ordination of laws, regulations and administrative provision relating to Community co-insurance. 78/473/ EEC, OJL 151, 7.6.78, P.25.

[87] Marie-Louise Rossi, *Changes in the Regulatory Environment in the UK*, in Etudes et Dossiers No. 230 REGULATION IN FINANCIAL SERVICES: IMPLICATIONS FOR SERVICES 2000, at 120(The Geneva Association, Geneva, 1999).

[88] Two major directives in this generation are developed to amend the directives in previous two generations, namely the Third Non-Life Directive (Council Directive, 92/49/EEC, 1992 ((O J L. 228/1))), and the Third Life Directive (Council Directive, 92/96/EEC, 1992 ((O J L. 360/1))).

[89] *See* T. HENRY ELLIS & JAMES A. WILTSHIRE, REGULATION OF INSURANCE IN THE UNITED KINGDOM AND IRELAND B.6-01 (Kluwer, Issue 53, August/1997).

The ICA has been amended by the Insurance Companies ("Third Insurance Directives") Regulation 1994 (SI 1994/1696) which came into force on 1 July 1994 ("the Third Directive Regulation")[90]. According to section 96(1) of the ICA 1982, an insurance company is defined as: "A person or body of persons (whether incorporated or not) carrying on insurance business." As for a reinsurer, however, the ICA does not define "insurance business" as including reinsurance business. It should be noted in this context, however, that in *Re NGR Victory Reinsurance Ltd.* (1995) 1 WLR 239 (Ch D) Lindsay J concluded that, for the purposes of the ICA, reinsurance business was included within the term "insurance business". After this case, it is judicially clear that reinsurance is to be regulated by the ICA 1982.[91]

After the main provisions of the Financial Services and Markets Act 2000 came into force on 1st December 2001, the Insurance Companies Act 1982 and the Insurance Companies Regulations 1984 were repealed and replaced by the FSMA 2002, the Financial Services Authority "Handbook of Rules and Guidance", and regulation and orders made under the FSMA 2000[92].

According to the Rule Interim Prudential Sourcebook for Insurance 2.1 (Rule IPRU ((INS))) issued by the FSA, every company whose business in the UK is restricted to reinsurance has to maintain its solvency margin in accordance with the Margin of Rules. Thus the requirements of solvency margins of a reinsurer are the same as that which applies to an insurance company who writes direct business and has its head office in the UK. In general, regulation of licensed reinsurers will include the following:

--"Solvency Margin

--Determination of Liability

--Valuation of Assets

--Matching liabilities with appropriate assets and localisation of assets

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[90] *See*, REINSURANCE PRACTICE AND THE LAW, LLP, at 1-17 (Colin Croly & Michael Mendelowitz eds., Issue No. 15-1 October 2000).
[91] *Id,* at 1-18 (Issue No. 15-1 October 2000).
[92] *See* Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001 (SI 2001/3649). With regard to the scope of insurance in FSA regulation, Part II of the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2001 (SI 2001/3544) specified the regulated activities. *See* P. L. Pruves, *The Expanding (or Shrinking) Scope of "Insurance " in FSA Regulation*, JOURNAL OF BUSINESS LAW, 2001, Nov. at 623-645.

--Annual returns[93].

Reinsurance company whose head office is in an "European Economic Area" (EEA) member state and which carries on reinsurance business is required to meet a financial solvency whereas "there is no requirement for EC and EEC direct insurers to demonstrate a solvency requirement in respect to their UK business as the responsibility for prudential supervision rests with the supervisors of the home member states.[94]" This is because EC reinsurers are not subject to supervision in the same way as other direct insurers[95] who benefit from the "single license system" developed in the "third generation" of EU Insurance Directives.

Since the EC Co-insurance Directive was introduced in 1978[96], reinsurers have been excluded from this requirement. As a result of the different controls between pure reinsurers and insurers, the UK has a tendency to regulate reinsurance activities in its own domestic market. Therefore, the onus of supervising a reinsurer from another EU member state which obtains an authorisation for a branch or agency in the UK is placed on the Financial Service Authority[97]. With respect to solvency requirements, pure reinsurers are required to maintain the same margins as that applied to a direct insurer having its head office in the UK[98]. In addition, the solvency margin requirements apply not only to the UK business of a pure reinsurer but also to its worldwide business[99].

An applicant, which is based in a country outside the EEA and wishes to transact either direct insurance or reinsurance business, needs to obtain an authorisation from the FSA. Generally speaking, non-EEA companies may be authorised to transact insurance business, if the FSA is satisfied that "(a) the applicant is a corporate body, entitled under the law of the place where its head office is

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93 *See* T. HENRY ELLIS & JAMES A. WILTSHIRE, *supra* note 89, at B.6-01-B.6-19 (Issue 72 May 2002).
94 *Id,* at B.5.2-01.
95 *Id,* at B.6-02.
96 Council Directive of 30 May 1978 on the co-ordination of laws, regulations and administrative provisions relating to Community Co-Insurance (78/473/EEC).
97 Before 5/1/1998, the UK regulatory authority for insurance was the Department of Trade and Industry. "On that date, these powers were exercisable by the Treasury Insurance Directorate (TID). On 18th November 1998, under the arrangements for the establishment of the Financial Services Authority (FSA), the Treasury Insurance Directorate (TID) transferred its responsibility under the Insurance Companies Act 1982 and the Financial Services Act 1986 to the Financial Services Authority." *Id,* at B-21 (Issue 72, May 2002).
98 *Id,* at B.6-01, B.6-02 *See also* Interim Prudential Sourcebook for Insurance Appendices 2.1 and 2.2.
99 *Id.* at B.6-02.

situated to effect and carry out contracts of insurance; (b) the applicant has in the UK assets of such value as may be prescribed; such assets must amount to a value at least equal to the minimum guarantee fund appropriate to the UK margin of solvency; and (c) the applicant has made a deposit in accordance with IPRU (INS) Chapter 8"[100]. However, the applications for authorisaton as to non-EEA direct insurance companies are stricter than those applicable to non-EEA pure reinsurance companies. For example, by virtue of Rule IPRU (INS) 8.1(1), the deposit requirement is not applicable in the case of a non-applicant for an authorisation restricted to reinsurance business only, whereas non-EEA companies who carry on direct general or long-term business are required to lodge a deposit of a certain prescribed amount with a nominated person[101].

b. Regulation of reinsurance arrangements of primary insurers in the European Union and the United Kingdom

Under the evolving EU insurance regulatory regime, the regulation of primary insurer's reinsurance arrangements is mainly covered by the requirement of "technical provisions"[102] which are designed to ensure insurance undertakings maintain sufficient acceptable assets to cover all underwriting liabilities. According to the EU's Third Insurance Directives[103], the debt owed by reinsurers can be treated as "acceptable assets" to cover technical provisions. Although the debt owed by reinsurers can be treated as acceptable assets under the EC Insurance Directives, this does not mean that the debt owed by reinsurers must automatically be accepted as cover under the technical provision requirements. Each member state is to lay down more detailed rules fixing the conditions for the use of acceptable assets: in this connection, a state may require valuable security or guarantees (e.g., letter of credit), particularly in the case of debts owed by reinsurers[104]. In addition, if the home Member State allows technical provisions to be covered by claims against reinsurers,

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[100] *Id,* at B.3.4-02 (Issue 72 May 2002).
[101] *Id,* at B.3.4-02 (Issue 72 May 2000).
[102] Each member stare shall require every insurer authorised by it 'to establish adequate technical provisions in respect of their entire business" (article 17, Third Non-Life Insurance Directive 92/49/EEC, 1992 O.J. (L.228/1) and article 18 Third Life Insurance Directives, 92/96/EEC, 1992 O.J. (L.360/1)). The rules regarding control over technical provisions are reflected in the provisions of the Annual Accounts and Consolidated Accounts Directives (91/674/EEC, O.J. L.374/7 1991).
[103] Article 21, Third Non-Life Insurance Directives 92/49/EEC, 1992 O.J. (L.228/1) and article 20 Third Life Insurance Directives, 92/96/EEC, 1992 O.J. (L.360/1).

it is to fix the percentage so allowed. Regarding the localisation of assets, the home Member State may not specify the localisation of the assets representing such claims[105]. To ensure diversification and adequate spread of investments, the Third Insurance Directive provides a set of admissibility rules that contain the quantitative limitation and six "guiding principles" for the home Member State to prescribe more detailed rules on admissibility of assets. With regard to reinsurance arrangements, the home Member State is to ensure that "limitations on particular categories of assets must take account of the treatment of reinsurance in the calculation of technical provisions[106]".

Regarding financial regulation of primary insurers in the United Kingdom, a primary insurer is required to maintain a minimum solvency margin and an amount of acceptable assets in excess of the insurance liabilities. In the field of non-life insurance, the minimum requirements are prescribed in IPRU (INS) Chapter 2. The liability is to be valued in accordance with IPRU (INS) Chapter 5 and the acceptable assets representing these liabilities and the solvency margin requirements are to be valued in accordance with the provisions IPRU (INS) Chapter 4[107].

Under these financial requirements for primary insurers, their reinsurance arrangements will be affected and regulated in the following aspects:

(1) The restriction of the reinsurance fraction on solvency margin requirement

Although the solvency requirement will be reduced by the reinsurance fraction, there is a restriction on the reinsurance fraction to 50% in the case of non-life insurers[108].

(2) Valuation of admissible assets

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[104] *See* Article 21 of Third Non-Life Insurance Directives and Article 21 of Third Life Insurance Directives. They provide that the home Member State must restrict acceptable investments to the following three categories: A. Investments, B. Debts and Claims, and C. Others.

[105] *See* Article 17 of Third Non-Life Insurance Directives and Article 18 of Third Life Insurance Directives.

[106] See Article 22 of Third Non-Life Insurance Directives and Article 22 of Third Life Insurance Directives.

[107] The detailed requirements for calculating the amount of the solvency margin are set out in regulation 17 of, and Schedules 3 and 4 to, the Insurance Companies Regulations 1994. *See* T. HENRY ELLIS & JAMES A. WILTSHIRE, *supra* note 89, at B.5.2-01 (Issue 72 May 2002).

[108] For a non-life insurer, the detailed requirements for calculating the amount of the solvency margin are set out in IPRU (INS) Appendix 2.1.

The EU Third Insurance Directive provides for diversification and an adequate spread of assets representing the technical provisions and for guiding principles for each member state to lay down more detailed rules fixing the conditions for the use of acceptable assets. In the United Kingdom, the current version of the valuation of assets regulations for the general insurance business is contained in IPRU (INS) Chapter 4[109]. According to Rule IPRU (INS) 4.5 (7), the value of a debt from or rights of recovery against a reinsurer is the amount that can reasonably be expected and to be recovered[110].

(3) Statements concerning major reinsurers and major cedants

The accounts and related financial statements are used to demonstrate the compliance with the solvency requirements as to the reinsurer, the amount of its admissible assets and the amount of its liabilities. These are a means by which the UK Financial Services Authority (FSA) on behalf of H. M. Treasury is able to monitor the financial condition of insurers. Insurers are to prepare accounts and other statements in prescribed form and to file copies of these accounts with the FSA in accordance with IPRU (INS). The precise form and content of the accounts are set out in the IPRU (INS) Appendix 9.1.

Under Rule IPRU (INS) regarding reinsurance arrangements, insurers are required to provide the accounting information about reinsurance business and to submit statements summarising the company's exposure to major reinsurers and major cedants, and the nature of any connection with each reinsurer and cedant[111].

2. United States of America-NAIC Model Law on Credit for Reinsurance

Insurance and reinsurance undertakings in the United States have primarily been regulated by the federal states since 1945[112], although there are some federal laws that either directly or indirectly apply to several important financial sector areas including banking, securities, employee benefits, liability risk retention, health insurance

[109] T. HENRY ELLIS & JAMES A. WILTSHIRE, *supra* note 89, at B.5.4-02-53 (Issue 72, May 2002).
[110] *See id.*
[111] *See generally* Rules IPRU (INS) 9.21, 9.25, 9.26 and 9.28.
[112] The McCarran-Ferguson Act 1945 has two principal aspects to deal with a legal and business crisis created by *South-Eastern Underwriters* (322 U.S.533 1944) case. It not only validates many activities of state regulation which would otherwise create an illegal interference with the sweeping powers of the Federal government under the Commerce Clause but also provides a limited federal antitrust immunity to the "business of insurance". See PETER M. LENCSIS, INSURANCE REGULATION

coverage, social security and some specific programmes that provide flood insurance in certain communities[113]. Due to the complexity and diversification of insurance and reinsurance regulations among the states, state insurance regulators created the National Association of Insurance Commissioners (NAIC) in 1871 to address the need to coordinate regulation of multistate insurers[114]. Among its tasks in harmonisation of insurance regulation, an important influence exerted by the NAIC is the adoption of "model laws and regulations", of which there are currently over 150[115]. As a matter of fact, a substantial amount of insurance and reinsurance regulation is initiated at the NAIC level, with individual states adopting model legislation or a modified version of NAIC model acts. Although the NAIC has no direct regulatory authority over the states, the NAIC accreditation process under which it grants or withholds accreditation of individual state insurance departments has been successful in moving states toward adoption of NAIC model acts[116].

Whereas the regulatory regime relating to the distribution of direct insurance mainly focuses on the party that will bear risk (the primary insurer), the regulation of

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IN THE UNITED STATES: AN OVERVIEW FOR BUSINESS AND GOVERNMENT 2-7 (Quorum Books, Connecticut 1997).

[113] In the area of banking, the primary federal sources of restrictions on banking entities with respect to the distribution of insurance products or underwriting activities are the National Bank Act (12 U.S.C. sec. 24.), the Bank Holding Company Act (12 U.S.C. sec. 1843) and the amendments to the Bank Holding company Act made by the Garn-St. Germain Act of 1982(12 U.S.C. Sec. 1843 (c)(8)).
Some insurance contracts (such as variable life and annuities whose payments rely on the fluctuating value of investment portfolios) are so much like non-insurance investments that they are considered "securities" under the Securities Act 1933 (15 U.S. C. Sec. 77a et seq.). The insurance companies that sell these products may be considered "issuers" of securities and "investment company" under the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1 et seq.)
In the field of employee benefits, the Employee Retirement Income Security Act of 1974 (ERISA) (P L. 93-406; 29 U.S.C. Sec. 1001 et seq.), provides vesting and funding requirement for private pension plans and generally regulates the design of pension and other benefit plans.
During the liability crisis, the federal Product Liability Risk Retention Act of 1981 (P. L. 97-45) was developed to allow commercial entities to create risk retention groups and purchasing groups under state supervision for product liability risks.
In addition, the Consolidated Omnibus Budget Reconciliation Act (COBRA) (P. L. 99-272) requires many employers to provide continuation of health insurance coverages for terminating employees and certain family members for a specific period.
The federal Social Security Act (42 U.S.C. Sec. 401 et seq.) was enacted in 1935 during the Great Depression to provide several programmes relating to disability insurance, hospital and medical insurance.
The National Flood Insurance Act of 1968 (P. L. 90-448 Title XIII) and the Flood Disaster Protection Act of 1973 (P. L.93-234) provide for the availability of flood and mudslide coverage to certain property owners in all states. PETER M. LENCSIS, *supra* note 112, at 9-12.

[114] *See* NAIC, *The NIAC-A Tradition of Consumer Protection*, (last visited July 28 2000), available at http://www.naic.org/1misc/aboutnaic/about/about01.htm.

[115] PETER M. LENCSIS, *supra* note 112, at 16.

[116] Debra J. Hall, *The Emerging Regulation of Reinsurance Intermediaries*, 42 DRAKE LAW REVIEW 859, 863 (1993).

reinsurance generally focuses on the party receiving coverage (the ceding insurer or the primary insurer) by limiting the financial accounting relating to admissible assets. The amount of debt owed by reinsurers cannot be deemed as admitted assets to cover or reduce technical provisions unless the reinsurers and reinsurance contracts meet certain statutory requirements[117]. In addition to these requirements, ceding of some portions of risks in particular lines of insurance business is often required by the statutes in most states. In the following subsections, several significant parts of regulation of reinsurance in the United States will be introduced and discussed respectively.

a. Regulations relating to conduct reinsurance business

An insurer is ordinarily authorised to carry on reinsurance business with its state of domicile, as to the same kinds of insurance it is authorised to write direct insurance. A significant amount of the reinsurance business in the United States, however, is conducted by reinsurers who are not licensed in the state where business is conducted. In general, state insurance departments will grant authorisation to the reinsurer who has been regulated and monitored by other state[118]. Therefore, the primary responsibility for regulation of multistate reinsurers rests with the reinsurers' state of domicile[119].

For licensed foreign insurers, they may provide reinsurance coverage without any particular authorisaton in some states. In other states, the foreign reinsurers are allowed to carry on reinsurance without any licensing authority[120]. In general, a reinsurer in the United States is said to be relatively free from regulation; however, their regulatory treatment, which may affect primary insurers' financial statement, differs depending on whether they are authorised or unauthorised in a state. Insurance regulation mandates that a primary insurer can only take a reinsurance credit to cover or to reduce its technical reserve if the transaction is made with an authorised reinsurer or if the reinsurance is supported by a cash deposit or other security for the

[117] *See* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *Legal and Regulatory Issues Affecting Insurance Derivatives and Securitization*, in SECURITIZED INSURANCE RISK STRATEGIC OPPORTUNITIES FOR INSURERS AND INVESTORS, at 85 (Michael Himick ed., Chicago 1998).

[118] *See* MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON & PETER R. KENSICKI, *supra* note 66, at 215.

[119] *See id,* at 216.

[120] *See* PETER M. LENCSIS, *supra* note 112, at 101.

reinsurer's obligations. In other words, state insurance departments indirectly regulate unauthorised reinsurers by employing financial requirements on a primary insurer that cedes risks to an unauthorised reinsurer[121].

In order to compile information on alien insurers and reinsurers, the Nonadmitted Insurers Information Office was formed as an adjunct to the NAIC. The main task of this office is to analyse the financial condition of each company and to provide a valuable service to state regulators who would otherwise not have adequate resources to analyse alien insurers and reinsurers[122].

b. Requirements relating to risk retention

In most states, a primary insurer is prohibited from permanently accepting or retaining more than certain specified amounts of risk and is required to obtain reinsurance to cede risks in excess of these amounts, such as one-tenth of the amount of their surplus on any one property or liability risk[123]. The main purpose of this requirement is to prevent a primary insurer from exposing itself to an ultimate loss arising out from insurance contracts.

c. Regulation of reinsurance arrangements of primary insurers

Regulation of reinsurance in the United States mainly focuses on the primary insurers and their reinsurance arrangements. According to the NAIC's Credit for Reinsurance Model Law, the value of reinsurance recoverable by a primary insurer from a reinsurer is considered as either an admitted assets or a reduction from technical reserve only if, and when the reinsurance is ceded to (1)an assuming insurer that is licensed to transact insurance or reinsurance in this state; or (2)an assuming insurer that is accredited as a reinsurer in this state; or (3) an assuming insurer that is domiciled in, or in the case of a U.S branch of an alien assuming insurer, a state that employs standards regarding credit of reinsurance substantially similar to those applicable under this statute, maintain the certain amount of surplus and submits to the authority of this state to examine its books and records; or (4) an assuming insurer that maintains a trust fund in a qualified U.S. financial institution for the payment of

[121] *See* MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON & PETER R. KENSICKI, *supra* note 66, at 215.
[122] *See* MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON & PETER R. KENSICKI, *supra* note 66, at 214-215.
[123] PETER M. LENCSIS, *supra* note 112, at 40.

the valid claims of its U.S. ceding insurers their assigns and successors in interest. Moreover, credit is to be allowed when the reinsurance is required by applicable law or regulation of that jurisdiction. In other words, credit will be allowed to ceding insurers that are mandated by these jurisdictions to cede to state-owned or controlled insurance or reinsurance companies or to participate in pools, guaranty associtaions or residual market mechanisms.

d. Regulation of reinsurance policy forms

Market conduct regulation designed to protect the insured party is generally inappropriate in the context of the regulation of reinsurance. Reinsurance transactions have been excluded from most regulatory systems regulating the relationship between the insured party and primary insurers. In general, state insurance departments do not require the same prior approval or informational filings for the wording used in reinsurance contracts as they do for primary insurance policy forms. Due to the complexity and diversity of reinsurance transaction, however, reinsurance terms and conditions may have a direct impact on the interests of policyholders and investors. Thus, state regulations require that specifying clauses, which may protect the interests of policyholders and the public, are to be included in a reinsurance contract with a primary insurer. In general, the following three clauses are to be included: (1) the "insolvency clause" states that reinsurance is not relieved of its liability arising out from reinsurance contract should the primary insurer become insolvent; (2) the "service of process clause" requires that the reinsurer have a legal representative within the United States who accept service on behalf of the reinsurer; and (3) the "intermediary clause" stipulates that the intermediary is an agent of the reinsurer for the purpose of receiving and transmitting funds[124].

e. Regulation of reinsurance intermediary.

In June 1990, the NAIC adopted the Reinsurance Intermediary Model Act, which requires a reinsurance intermediary be licensed and to comply with other specific requirements. Reinsurance intermediaries under this Act are divided into two types: reinsurance brokers and reinsurance managers[125]. In addition to the licensing

124 *See* MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON & PETER R. KENSICKI, *supra* note 66, at 216.

125 A reinsurance broker means any person, other than an officer or employee of the ceding insurer, firm, association or corporation who solicits, negotiates or places reinsurance cession or retrocessions on behalf of a ceding insurer without the authority or power to bind reinsurance on behalf of such

requirements and the obligation imposed upon the contracting parties, the Act presents various model provisions addressing the obligations of ceding company clients or reinsurer clients and applying penalties against reinsurance intermediaries, insurers and reinsurers who violate the regulatory acts.

3. A Comparative Analysis on the Structures of the Reinsurance Regulation

In comparing the two developed models of the EU-UK and the U.S., several fundamental differences between them can be identified as follows:

First, regarding the licensing requirements and authorisation of reinsurers, the regulation of reinsurers in the European Union has not been harmonised and varies in every member state. In the UK model, the requirement of solvency margin of a reinsurer is the same as that which applies to an insurance company who writes direct business and has its head office in the UK. Unlike other EU direct insurance companies, reinsurance company whose head office is in an EEA member state and which carries on reinsurance business is required to demonstrate its financial solvency. In addition, an applicant, which is based in a country outside the European Economic Area, needs to obtain an authorisation from FSA before carrying on reinsurance business.

With regard to licensing requirements of reinsurers in the United States, an insurer is ordinarily authorised to carry on reinsurance business within its state of domicile, as to the same kinds of insurance as it is authorised to write direct insurance. As for the reinsurance business conducted by reinsurers who are not licensed in the state where business is conducted, state insurance departments will grant authorisation to the reinsurer who has been regulated and monitored by another state. On the contrary, in some states, the foreign reinsurers are allowed to carry on reinsurance without any licensing authority. In other states, they may provide for reinsurance coverage which is of the same kind of direct insurance as to which they are licensed to carry on without any specific authorisaton. As a general proposition, it seems that reinsurers in the United States are relatively free from regulation. It should be noted, however, that their regulatory treatments, which may affect primary insurers' financial statement, differ and depend on whether they are authorised or

insurer. A reinsurance manager, on the other hand, is defined as any person, firm, association or corporation who has authority to bind or manages all or part of the assumed reinsurance business of a unauthorised in a state. In other words, state insurance departments indirectly regulate unauthorised reinsurers by employing financial requirements on primary insurers that cede risks to unauthorised reinsurers.

Secondly, the differences between US and UK regulatory regimes exist with respect to the regulation relating to reinsurance arrangements of insurers According to the EU's Third Insurance Directive, the debt owed by reinsurers can be treated as acceptable assets to cover technical provisions. Each member state may require valuable security or guarantees, particularly in the case of debts owed by reinsurers. In addition, if the home Member State allows technical provisions to be covered by claims against reinsurers, it is to fix the percentage and ensure that limitations on particular categories of assets is to take account of the treatment of reinsurance in the calculation of technical provisions.

Regarding financial regulation of primary insurers in the United Kingdom, reinsurance arrangements of primary insurers are regulated and monitored by regulators in the following aspects. There is a restriction on the reinsurance fraction respecting the solvency margin requirement. Further, the amount of value of reinsurance recovery against a reinsurer can reasonably be expected and recovered. Moreover, insurers are required to submit statements summarising the company's exposure to major reinsurers and major cedants, and the nature of any connection with each reinsurer and cedant.

Compared with EC insurance directives and the United Kingdom model, regulation of reinsurance arrangements of primary insurers in the United States appear more complicated, detailed and stringent.

Regarding the requirement of risk retention, if primary insurers insure any risks above certain specified amounts, they are required to obtain reinsurance for the excess portion in most states. Although both the EU and the United States recognise that reinsurance recoverables can be treated as admitted assets under their respective statutory accounting principles, the value of reinsurance recoverable in the United States can be recognised by the regulators only if the reinsurer is licensed in the regulator's state or otherwise approved as an accredited foreign or alien insurer. In the case of ceding to foreign reinsurers who are not accredited by a state insurance

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reinsurer (including the management of a separate division, department or underwriting office) and acts department, primary insurers can not take credit of reinsurance unless the reinsurers have provided (1) a deposit of cash or securities with the ceding companies, or (2) an amount of cash or securities in trust with a domestic bank or other suitable trustee, or (3) an irrevocable letter of credit issued by an acceptable bank to secure the reinsurer's obligations[126].

Thirdly, market regulation designed to protect the insured parties is generally inappropriate in the context of the regulation of reinsurance. Reinsurance transactions have been excluded from most regulatory regimes regulating the relationship between the insured party and primary insurers. Although reinsurance terms and conditions may have a direct effect on the interests of policyholders and investors in some cases, reinsurance terms and conditions are only regulated by specific regulations in the United States.

D. Regulatory Issues relating to Reform on the Structure of Reinsurance Regulation in Emerging Markets

An alternative regulatory system would be to safeguard the financial soundness of primary insurers. Under this system, supervisors are to ensure their ability to review reinsurance arrangements, to access the degree of reliance placed on these arrangements and to determine the appropriateness of such reliance. An insurance supervisor would assess the collectability of the reinsurance recoverables to compute the amount of the applicable reinsurance, which can take the credit to cover the technical reserve, on the net reserving basis. In addition, the assessment of the collectability of the reinsurance recoverables would take into account the supervisory control over the reinsures for the reason that reinsurance transactions often operate on the cross-border basis. In order to obtain accurate information to establish the method for collection and monitoring of information relating to reinsurers, it would be essential for an insurance supervisor to enhance international cooperation and information exchange relating to regulation and supervision.

It would appear, notwithstanding the need to adhere to international liberalisation trend in a sequenced and managed manner, this alternative regulation system to safeguard financial stability appears best suited for emerging countries. Yet, many emerging countries have sought for expediency to copy the developed models

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as an agent for such reinsurer whether known as a RM, manager or other similar term.

operating on certain industrialised countries[127]. It is evident, however that the attempts to copy the "ready-made" law of industrialised countries will fail unless awareness of particular social, economic and legal differences has been taken into account[128]. Several issues arise when considering formulating reinsurance regulation reform in emerging market.

1.Conflicts between Regulation of Reinsurers and the Diversification of Insurance Risk

As mentioned above, the regulation of reinsurers in the UK and US models tends to regulate reinsurers in their domestic jurisdictions. For example, reinsurers who wish to carry on reinsurance business in the UK should obtain the authorisation from the FSA[129]. Should the same regulatory model be adopted by an emerging market, simply because it seems that such a developed model proved to be successful in these developed countries?

On the one hand, direct regulation of reinsurers can promote the regulators' control on reinsurers by means of licensure, financial solvency requirements and market conduct control (e.g., contract wording, fraud). While the markets become liberalisation, the insurers may find it more difficult to assess the reinsurer's creditworthiness and to deal with legal dispute arising from reinsurance contracts. In direct supervision of reinsurers, this will provide an uniform of assessment for regulators and insurers and should make it become easier to settle dispute in the same jurisdiction.

On the other hand, regulation of reinsurers may lead to excessive transaction costs, operational obstacles and increased supervisory costs. The licensure of reinsurers means that reinsurers should be subject to relevant investment requirements and capital requirements. This will increase operational obstacles for those foreign reinsurers. Consequently, this would establish a barrier to entry into a domestic market and hence to damage the diversification of insurance risk.

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[126] *See* PETER M. LENCSIS, *supra* note 112, at 40.

[127] This is because these industrialised countries' models proved to be successful and the emerging countries need to speed up their regulation reform. *See generally* JOSEPH J. NORTON, *supra* note 54, at 130.

[128] "..., [E]xperience shows that no government can expect to develop their own model by copying a developed country's successful model. These developing countries should benefit from comparative law methodology, but they should not rely on ready-made laws which operate, substantially, in different economic, social and legal environments. " *Id,* at 130-132.

Unlike developed reinsurance markets, the main problem in the emerging markets is the lack of capacity for risk[130] and expertise. By adopting direct regulation, it, more probably, will cause a shortage of coverage for the risk that insurers have assumed. Therefore, the successful developed models in developed markets may be inappropriate for adoption by emerging market.

2.Regulation of Reinsurance Arrangements and Cross-border Reinsurance Transactions

Cross-border reinsurance transactions can be difficult to track and to obtain information relating to financial condition of reinsurers. Additionally, the cross-border aspect will increase uncertainty of reinsurance payment. Foreign insurers may not be subject to the same degree regulatory regime as domestic insurers[131]. In the United States, international reinsurers who wish to carry on reinsurance business should meet specific collateral requirements[132]. By doing so, the ceding insurers can obtain the credit of reinsurance to reduce the loss reserve in their financial statements. The use of collateral requirements may prevent domestic insurers from difficult collection problems arising from foreign reinsurers[133] and may reduce the uncertainty of reinsurance payments.

From the viewpoint of insolvency law, collateral requirements may create certain classes of preferential creditors and may act to the detriment of other classes of other policyholders and creditors[134]. As mentioned above, it is difficult to define such collateral requirements as either a form of prudent regulation in the interests of the general public or a discriminatory measure against foreign reinsurers. Although the use of collateral requirements can reduce collection problems, *de facto* discrimination still might occur. It is inevitable that such requirements will increase the transaction

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[129] *See* Section II, C,1 of this chapter.

[130] *See* IAIS Working Group on Reinsurance, "Reinsurance and Reinsurers: Relevant Issues for Establishing General Supervisory Principles, Standards and Practices", IAIS, (Feb. 2000), p.11.

[131] *See* IAIS Working Group on Reinsurance, *Reinsurance and Reinsurers: Relevant Issues for Establishing General Supervisory Principles, Standards and Practices*, at 27, (Feb. 2000) available at <www.iaisweb.org>

[132] In the case of ceding to foreign reinsurers who are not accredited by state insurance departments, primary insurers can not take credit of reinsurance unless the reinsurer have provided (1) a deposit of cash or securities with the ceding company, or (2) an amount of cash or securities in trust with a domestic bank or other suitable trustee, or (3) an irrevocable letter of credit issued by an acceptable bank to secure the reinsurer's obligations.

[133] *See* IAIS Working Group on Reinsurance, *supra* note 131, at 27.

[134] *Id,* at 27.

costs of reinsurance. Consequently, they may impose indirect restrictions on the cross-border transactions and then impede the diversification of insurance risks.

3. Assessment of Security of Reinsurers and International Supervisory Standards

It is recognised that the lack of reinsurance coverage is the main problems as to emerging markets[135]. Regulators in emerging countries not only have to promote liberalisation of reinsurance transactions but also have to ensure the security of reinsurance payments. To avoid any distortion of freedom of reinsurance activities, regulators need to reconciliate the conflicts between prudential regulation and the diversification of insurance risk.

With regard to direct regulation of reinsurers, a registration system (e.g., UK)[136], that is less stringent, might be introduced while the licensure of reinsurers may damage the freedom of reinsurance activities and may increase further transaction costs. Under this system, reinsurers are required to demonstrate their financial condition and relevant regulation to which they are subject before authorisaton is granted. In the UK model, an applicant from another EEA member state for a reinsurance authoristaion would need authorisation from the FSA. For the applicant who is outside the EEA, the applications of authorisaton are stricter than those applicable to non-EEA pure reinsurance companies. For example, according to Rule IPRU (INS) 8.1.(1), the deposit of requirement is not applicable in the case of a non-applicant for an authorisation restricted to reinsurance business only.

It should be noted, however, that several steps have to be taken before such a system is introduced and enacted. First, the official assessment of the financial condition of reinsurer should be established. Such an assessment should be based on generally accepted accounting standards. Second, regulators should be able to obtain accurate information by enhancement of cooperation between regulators throughout the world. Third, regulators should comply with high standard of expertise to use the assessment.

In emerging market, regulators often have insufficient experience and expertise to assess the financial condition of reinsurers particularly as to some

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[135] *Id,* at 11.

[136] *Id,* at 3 *See also* further discussions in Chapter Two.

advance reinsurance products such as finite risk reinsurance and insurance-linked securities. In addition, the establishment of their own assessments is a difficult task. For emerging markets, the use of rating agencies can be an alternative tool of assessment as they can provide useful criteria for primary insurers to select reinsurers.[137]

From the viewpoint of harmonisation of supervisory standards, the "mutual recognition" used in European Union countries seems successful. Although the "single passport system" for reinsurers still has not been adopted by the EU, the proposal to adopt a single license system has been suggested by the CEA (Comitè Europèèn des Assurances)[138]. In the long-term as to developing a single passport system for reinsurance activities, appropriate international supervisory standards should be established first to reduce legal uncertainty and transaction costs. This will also benefit the emerging countries in developing their own reinsurance regulations and in promoting fair competition and the diversification of insurance risks.

III. Regulatory Reform on the Purposes and the Structure of Reinsurance Regulation in Emerging Markets: The Case of Taiwan

In the case of Taiwan, which shares the common characteristics with other emerging markets, there is a pre-existing regulatory system and a particular market environment that can not be ignored. This observation leads to one of the main themes of this volume; that is, the reform of reinsurance regulation should take into account its specific circumstances in each country. It is in this context that the Taiwanese reinsurance market is used as a case study. As such, two general aspects of reinsurance regulation in Taiwan, namely the purposes of its reinsurance regulation and the structural reform on its reinsurance regulatory regime, will be addressed respectively. In this connection, this research is intended to identify the contour of the current problems relating to reinsurance regulation in Taiwan, and then to submit selective suggestions in this respect by comparative reference to developed models including the EC insurance directives, the United Kingdom and the United States.

A.Taiwanese Reinsurance Regulatory Regime and the Potential Problems

[137] *See* MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON & PETER R. KENSICKI, *supra* note 66, at 201.

With regard to regulatory regime in Taiwan, the domestic Insurance Law prescribes the supervisory authority, the Ministry of Finance, as being responsible for supervising any undertakings carrying on insurance business. The Insurance Law governs the insurance contract and also provides the regulatory requirements for insurance enterprises. Among the Insurance Law, there is only one article concerning reinsurance arrangements of insurers. In order to prevent insurers from risk exposure, it requires that risk retention of insurers shall not exceed one tenth of the aggregate amount of the capital or foundation fund, the surplus, the special reserve and the retained earnings[139].

To ensure the control on the ceding business of insurers and to protect its domestic reinsurance market and balance of payment situation, the Central Reinsurance Corporation Act (CRCA) was enacted in 1972. This Act provides for the main part of the reinsurance regulatory regime in Taiwan. According to Article 6 of the CRCA, Central Reinsurance Corporation (CRC)[140] was established in 1968 by the government. The CRC is responsible for taking priority cessions from all authorised insurers in Taiwan although the insurers are permitted to make cessions to foreign reinsurers pursuant to several exemptions[141]. In other words, all authorised insurers are to make priority cessions of all lines business to the CRC unless they meet the conditions established by the Ministry of Finance. In addition to CRCA, Rules Governing Ceding Business to Foreign Insurers made by the Ministry of Finance contain substantial provisions that authorise insurers to obtain the approval to cede to foreign reinsurers without compulsory cessions to CRC if foreign reinsurers can provide more favorable coverage than the CRC can[142]. In practice, the minimum cession made on a quota share basis to the CRC is 10% and the average is 15%[143]. Except for compulsory cessions to the CRC, insurers in Taiwan are free to reinsure abroad without any restriction. As a result, the main purpose of Taiwanese

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[138] Michael Pickel, *Panel On Reinsurance Regulation: The Importance Of Global Regulation of Reinsurers Seen From The Point Of View Of A German Reinsurer*, in Seventh Annual Conference of The IAIS, at 6 (Cape Town, 10 October 2000).

[139] Insurance Law (Taiwan ROC) (amended) 2001, art. 147.

[140] Central Reinsurance Corporation is the solo professional reinsurer in Taiwan and one of only two Asia reinsurers (along with Korean Re) to be listed in Standard & Poor's Top 100 Reinsurers listing. BARBARA HADLEY, INSURANCE IN ASIA 109 (Financial Times, 1998).

[141] Central Reinsurance Corporation Act 1972, art 2.

[142] Article 3 and 4 of Rules Governing the Ceding Business to Foreign Insurers (amended) 1981, M.O.F.(70), no. 15498.

reinsurance regulation is based currently on local protectionism rather than on maintaining the financial solvency of insurers.

With regard to the reinsurance market in Taiwan, in 1998 premiums ceded to an internal reinsurance market were estimated to be around TWD 19,804 million (USD 633 million) whereas premiums ceded abroad were estimated at TWD 30,942 million[144]. The percentage of non-life direct premium income ceded abroad in 1998 was 40.80%[145]. This shows that foreign reinsurers have significant influence on the Taiwanese reinsurance market, and the financial condition of such reinsurers might have a direct impact on domestic insurers. In addition to foreign reinsurers, reinsurance brokers also play an essential role to cede "facultative business" abroad since most "treaty business" is concluded directly with reinsurers[146].

In spite of the important role that the foreign reinsurers and brokers play in the Taiwanese reinsurance market, the domestic regulation of reinsurance is far from comprehensive and sound in ensuring the financial solvency of insurers. This is because, as mentioned above, the primary purpose of domestic reinsurance regulatory regime is based on local protectionism rather than on enhancing the financial solvency of insurers in Taiwan. The Insurance Law only contains one provision concerning risk retention of the insurers. Apart from that, the CRCA provides limited regulatory functions by using compulsory cessions.

As a result of the inadequacy of solvency regulation concerning reinsurance in Taiwan, it is reasonable to assume that potential risk might arise while the reinsurance market increasingly becomes internationalised after the establishment of WTO/GATS and Taiwan's entry in this world trading regime. Under these circumstances, the insurers may face competitive challenges from other foreign insurers. In order to maximum their profit opportunities, they may change their strategy and management to expand their business by using reinsurance as a "substitute capital". As a result, the insurers might neglect the quality of the reinsurance and credit risks of the reinsurers if appropriate solvency regulation are not been enacted and applied.

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143 AXCO, INSURANCE MARKET REPORT ON TAIWAN-NON-LIFE 33 (AXCO Insurance Information Services, July 2000).
144 *Id,* at 35.
145 *Id,*at 34.
146 *Id,*at 39.

The legal instruments used by the GATS[147], the Annex, is an integral part of the GATS, is designed to be the framework agreement to provide greater specificity, covers reinsurance among other insurance services[148]. Additionally, each GATS member state should not employ any measures for protectionism, although each country has its own right to take any measures for *prudential* reasons[149].

As for cross-border trade in financial services, the GATS *Understanding on Commitments in Financial Services* requires that each member state is to "permit non-resident supplier of financial services to supply financial services beyond those enumerated in the Annex on Financial Services as a principal, through an intermediary or as an intermediary[150]." The Understanding regarding cross-boarder covers several commercial insurance services including maritime shipping, commercial aviation, space launching, freight, hull cargo, and liability, goods in international transit, reinsurance and retrocession[151]. As a result, foreign insurers shall be permitted to conduct reinsurance and retrocession in the domestic market by domestic regulation.

Fostering the trend of globalisation, the GATS mandates that unnecessary barriers and restriction to entry domestic reinsurance market are to be abolished. For example, the regulation relating to compulsory cessions to CRC used as a means to protect domestic reinsurance market and the national currency may violate the GATS. Further, international supervision standards should be considered and applied into Taiwanese regulatory system. In recent years, international "institutions" have

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[147] *See generally* J. Steven Jarreau, *Interpreting the General Agreement on Trade in Services and the WTO Instruments relevant to the International Trade on Financial Services: the Lawyer's Perspective*, 25 NORTH CAROLINA JOURNAL OF INTERNATIONAL LAW AND COMMERCIAL REGULATION 1 (Fall 1999). Aly K. Abu-Akeel, *Definition of Trade in Services Under the GATS: Legal Implications*, 32 GEORGE WASHINGTON JOURNAL OF INTERNATIONAL LAW AND ECONOMICS 189 (1999); Joel P. Trachtman, *Trade in Financial Services under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis*, 34 COLUMBIA JOURNAL OF TRANSNATIONAL LAW 37 (1995).

[148] *See* General Agreement on Trade in Services, Apr. 15 1994, Marrakesh Agreement Establishing the World Trade Organisation, Annex 1B, Legal Instruments-Results of the Uruguay Round vol. 28 (1994), 33 I.L.M. 1167 (1994)., cited by J. Steven Jarreau, supra note 147, at 36.

[149] "Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial system. Where such measures do not confirm with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement". *See* Section 2 (a) of the Annex on Financial Services. *Id,* at 36.

[150] *Id,* at 57-58.

[151] *See* Section 3 (a) and (b) of Understanding on Commitments in Financial Services, Apr, 15, 1994, Results of the Uruguay Round-Legal Texts 477 (1994), 33 I.L.M. 1260-63 9(1994). *Id,* at 57.

developed several minimum supervisory standards in order to provide a similar level playing field for reinsurers and to promote a fair competitive environment. The main purpose of these *guidelines* and *principles* is to ensure that regulators have the ability to review reinsurance arrangements, to assess the degree of reliance placed on these arrangements and to determine the appropriateness of such reliance. In comparison to these international supervisory standards, it appears that the reinsurance business of the ceding insurers in Taiwan is largely free from prudential regulation, notwithstanding the compulsory cessions to a state-owned reinsurer. As a matter of fact, the Taiwanese reinsurance regulation can control neither the insurer's selection of reinsurers nor the reinsurance programmes.

Moreover, the current reinsurance regulation in Taiwan lacks a comprehensive and viable tool for supervising and monitoring reinsurance activities. Due to inadequate regulations that delegate authority to insurance regulators, the insurance regulators only can rely on the financial statements provided by the ceding insurers in supervising the ceding business of the insurers. However, approval standards relating to selection of reinsurers and reinsurance arrangements have not been prescribed in the relevant regulations. In addition to reinsurers and insurers in the reinsurance market, such regulations should consider the reinsurance intermediaries which act as the agents of reinsurers or insurers. As a result, the regulation of reinsurance intermediary should be included in the reinsurance regulatory regime although the reinsurance intermediary in Taiwan are free from specified regulation regarding licensure, supervision of market conduct, and solvency regulation.

In terms of a comprehensive and viable regulation, the Taiwanese regulators should be able to supervise the ceding business of the insurers and also provide a fair competitive regulatory environment for domestic and foreign reinsurers. While the needs of prudential regulation increases, the development of new regulatory regime should avoid "over-regulation" that may increase transaction costs and may unduly reduce market competition.

B. Purposes of reinsurance regulation in Taiwan

For the variety reasons mentioned above, it is difficult to define and to determine the priority of purposes of reinsurance regulations for emerging markets. On the case of Taiwan, the author has the following suggestions.

1. Maintaining the financial solvency of primary insurers in reinsurance arrangements

As mentioned above, the regulation of reinsurance mainly deals with the relationship between solvency of primary insurers and their reinsurance arrangements. To what extent reinsurance will affect the solvency of primary insurers depends the method to calculate the technical reserve, which is designed to ensure that an insurer will match all its known liabilities.

Among some countries on the gross reserving basis, regulators can monitor the financial condition of insurers without control on their reinsurance arrangements because the financial security of reinsurance is achieved by the requirement of the deposit of premium reserves and outstanding liability reserves. It should be noted, however, that the stringent deposit requirement will deprive reinsurers' freedom of investment, interest earnings and consequently will result in the extract cost which will be passed on to the final consumer party. In addition, it has increased the adverse effect on global reinsurance market. Thus, many countries adopt the net reserving basis and permit that primary insurer can cover its technical reserves by applicable reinsurance arrangements.

In this connection, Taiwan also adopts the similar regulatory mechanism to allow that primary insurers can hold reinsurance recovery as a substitute for capital. In such circumstances, reinsurance recovery has a direct impact on the financial solvency of primary insurers in Taiwan. Furthermore, the transfer (ceding) of risk abroad is a common practice in Taiwan. Reinsurance capacity of non-life insurance industry in Taiwan relies heavily upon the supply from the international reinsurance market. Thus, it is essential for a regulator not only to promote primary insurers to spread their risk efficiently and internationally but also to enhance the regulatory mechanisms to ensure the security of reinsurance recovery. While other developed countries have established and employed several regulatory mechanisms to monitor reinsurance arrangements, however, regulations in Taiwan are still insufficient to prevent primary insurers from credit risk relating to default of reinsurers. In Chapter Two, this issue will be further discussed.

2. Promoting liberalisation and fair competition in insurance and reinsurance market.

The reinsurance regulation in Taiwan was mainly designed to protect local insurance market and balance of payment. According to CRCA 1972, state owned reinsurance company-Central Reinsurance Corporation is required to assume a specified portion of business ceded by primary insurance companies in Taiwan [152]. In order to enhance underwriting capacity, promote risk retention of local insurance industry and protect national currency, Central Reinsurance Corporation also operates as a local pool organisation and conducts a certain amount of retrocession to local primary insurers.

Due to the trend of liberalisation and globalisation, the barrier to trade in reinsurance will be dismantled gradually by the WTO in which the Taiwanese government has made its endeavour to participate. While some reinsurance regulations affected the free access to international reinsurance market will be avoided, however, the alternative regulatory system to safeguard the financial soundness of primary insurers and reinsurers should be established and implemented. In this connection, except the financial solidity of primary insurers mentioned above, government should enact and enforce laws that provide reasonable solvency standards for reinsurance companies. It means that government not only should liberalise local reinsurance market to foreign competitors but also establish prudential regulation relating to solvency standards. In addition, it is essential to establish specific regulations to deal with the issues relating to reinsurers.

With respect to the trend of consolidation of international reinsurance market, it is reasonable to assume that more attention might be paid to the competition policy and anti-competitive behaviour relating to mergers and arrangements among reinsurers. Government should not only enact and enforce laws that provide an effective framework for competitive reinsurance market[153] but also enhance international co-operations to prevent anti-competitive practices arising from international reinsurance groups.

In the following section, the structure reform will be suggested along with the purpose of reinsurance regulation to ensure solvency of insurers and promote fair competitive market.

C. The Structure Reform on Reinsurance Regulatory Regime

[152] Central Reinsurance Corporation Act (Taiwan ROC) 1972, art. 6 (1).
[153] *See* Harold D. Skipper, Jr., *supra* note 55, at 201.

To ensure a well-structured competitive and solvent insurance market, each government's intervention into its market should be reassessed to ensure that the essential purposes are being accomplished with minimum market disruption[154]. Respecting the Taiwanese regulatory reform as to the reinsurance regulation, it remains difficult to define the priority of regulatory purposes. On the one hand, the increased regulation imposed on the foreign reinsurers may protect domestic reinsurers and may make it easier to settle legal disputes between reinsurers and insurers in the same jurisdiction. On the other hand, this may cause significant damage to diversification of insured risks. Consequently, "any restriction on this diversification as a result of over-regulation is of detriment to both the cedant and reinsurer.[155]" Additionally, unnecessary transaction costs may arise with the increased costs finally be passed on to the policyholders. To reconcile these conflicts, desirable regulations should ensure the security of foreign reinsurers, yet also should promote the diversification of insured risk.

In order to achieve this particular purpose in Taiwan, the regulatory regime should be restructured on a comprehensive basis, which means that all the parties relating to reinsurance transactions should come within the scope of regulation. Such a comprehensive and viable regulatory regime should include reinsurers, insurers and reinsurance intermediaries. Furthermore, international supervisory standards should not be neglected while developing this new regulatory regime. Prudential regulations compatible with international standards should be introduced and implemented, in a realistic manner, to ensure the financial solvency of reinsurers and insurers. As a result, the Taiwanese regulators should endeavor to ensure their ability to assess the quality of reinsurance of insurers and to enhance international cooperation between the host regulators and home country supervisors.

To ensure the solvency of insurers, the appropriateness of the reinsurance programme should be examined and assessed by the regulators. The host regulators should be able to obtain the accurate information relating to the financial condition of reinsurers and the quality of the home country regulation. In order to obtain such information, more attention should be paid to developing a working framework of international cooperation among domestic regulators and foreign regulators, and to

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[154] *See* Harold D. Skipper, Jr., *supra* note 55, at 200.
[155] Michael Pickel, *supra* note 138, at 3.

international accounting standards, that seeks to provide greater comprehensibility and reliability.

In terms of specific structural reforms respecting the Taiwanese reinsurance regulation, the following are suggested:

1.Regulation of reinsurance arrangements of primary insurers

With regard to primary insurers' reinsurance arrangements, three essential issues should be considered prudentially, namely risk retention of business written by primary insurers, security of placing reinsurance with reinsurers and accounting regulations.

a. Risk retention of business written by primary insurers

In order to improve primary insurers' capacity of obtaining business, to stabilize insurers' profits, and to strengthen their financial solvency, it is important for primary insurers to spread their risks more efficiently through reinsurance. To prevent primary insurers from exposing themselves to an ultimate loss arising from liability under insurance contracts, many countries prohibit them from accepting or retaining more than a certain specified amount of business. A similar regulatory mechanism has been adopted by Taiwanese regulatory regime. Primary insurers are required to obtain reinsurance to cede risks in excess of one-tenth of the amount of their surplus on any one property or liability risk[156].

On the contrary, the more dependent a primary insurer's capacity is upon its reinsurance arrangements, the more dependent is its solvency upon the security/creditworthiness of reinsurance. Furthermore, a primary insurer would operate as a broker and rely on reinsurance commission if it does not retain a substantial proportion of its business[157]. Therefore, some countries may either restrict primary insurer's reinsurance premium to a certain amount of total gross premiums, or may impose a high solvency requirement on an insurer whose business is heavily reinsured through restricting the reinsurance fraction to a certain proportion of overall business (*e.g.*, 50% restriction for a non-life insurer in the United Kingdom). Similar requirements have not been adopted by the Taiwanese regulatory regime.

b. Security of placing reinsurance with reinsurers

[156] Insurance Law (amended) 2001 (Taiwan), art. 147.

According to the principles established by its IAIS, as mentioned above, regulators should ensure an ability to review reinsurance arrangements, to assess the degree of reliance placed on these arrangements and to determine the appropriateness of such reliance. In comparison with these standards, reinsurance regulations in Taiwan appear less developed than those standards suggested by the IAIS. Due to lack of substantial regulations, it is not clear that the Taiwanese regulators have any real specific control power or ability to intervene in issuing any order in the reinsurance context. In addition, the requirements, which should reflect an assessment of the ultimate collectability of the reinsurance recoverables, still have not been employed and established in the Taiwanese regulatory system. With regard to supervisory control over the reinsurers, except for reinsurance business accepted by the CRC and other domestic insurance companies, reinsurers who are incorporated in another jurisdiction can carry on reinsurance business without specific authorisation. Furthermore, due to the complexity of monitoring a reinsurer's financial creditworthiness, regulators in Taiwan should enhance their expertise in forming sound judgements about financial solvency of foreign reinsurers.

Although the assessment of financial solvency of reinsurers relies heavily upon the insurance rating services (*e.g.,* AM Best, Standard & Poor) in Taiwan as well as in other emerging markets, it has been suggested that a sound supervisory approach should be based more on "mutual recognition" of other countries' supervisory systems. In this case, foreign reinsurers could obtain authorisation to carry on their reinsurance business through demonstrating their financial solvency by being listed as part of a set of approved reinsurers[158]. As alluded to above and as will be discussed in subsequent chapters, in addition to traditional reinsurance that transfers liability for potential future losses arising from actual insurance underwriting risks, alternative risk-financing mechanisms to transfer insurers' financial risk have been developed and can be categorised into four types of financial structures: finite risk reinsurance, securitisation of risk, insurance derivatives, and liquidity and contingent capital facilities[159].

[157] *See* Peter Falush, *supra* note 6, at 266.
[158] *See* Peter Falush, *supra* note 6, at 266.
[159] *See* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *supra* note 117, at 80-82.

Finite risk reinsurance and securitisation of risk may be affected by the reinsurance regulatory regime. Finite risk reinsurance is often considered as financing arrangements under applicable accounting and reporting models, because there is an obligation to repay the funds provided and it can principally address "timing risk", with "less-than-complete transfer of subject underwriting risk"[160]. Apart from traditional risk-financing structure-reinsurance arrangements, securitisation of risk typically involves "the funding of traditional property and casualty risk through capital market transactions not traditionally applied to property and casualty risk"[161].

Although securisation of risks has not been used as an alternative risk financing technique in Taiwan, finite risk reinsurance is being used increasingly to fund time risk, investment risk and other financial risk. Due to lack of specified accounting regulations, however, the use of finite risk reinsurance has not been supervised under applicable domestic accounting and regulation.

Legal and regulatory issues affecting finite risk reinsurance and securitisation of risk will be further discussed in Chapter Four.

c. Accounting regulations

The primary purpose of accounting regulation is full disclosure of the insurer's financial condition to regulators, policyholders, other interested parties and the general public. Following developing prudential solvency regulations, assessment of the financial impact of reinsurance arrangements will heavily rely upon the insurers' financial reports; these commonly include the annual report, the balance sheet and profit and loss accounts. In order to assess the degree of reliance placed on reinsurance arrangements and to determine the appropriateness of such reliance, it is important for primary insurers to provide comprehensive and detailed financial reports concerning reinsurers and its financial impact of reinsurance arrangements, including retention, technical reserves and reinsurance contracts. Consequently, some reliable method of evaluating the creditworthiness of reinsurers is needed. These methods should be based on the accounting standards which are acceptable and recognised by most countries[162],. With the trend toward internationalization of accounting standards in order to provide greater transparency and

[160] *Id*, at 80.
[161] *Id*, at 77.

comprehensibility[163] for regulators, insurers and the general public, Taiwan should consider facilitating the use of such international accounting standards.

2. Regulations of accepted reinsurance activities

Although the principles established by the IAIS and the OECD do not provide specified standards for supervising those who accept reinsurance business, it is well recognised that insurance undertakings which accept reinsurance business should maintain financial soundness and should be monitored by regulators. Regulators, in turn, should be able to supervise pure reinsurers and to monitor insurance companies which underwrite reinsurance business and direct insurance business.

Due to particular market characteristic, specific regulations for pure reinsurers have not been established and implemented in Taiwan. Following the privatisation of CRC, it seems desirable now for Taiwan to develop and to enact specific regulations relating to entry requirements, financial solvency regulations and on-going supervision for those who intend to establish reinsurance companies in Taiwan.

For insurance companies which accept direct insurance and reinsurance, the acceptance of reinsurance business, which can be a high risk business, may have a direct impact on the financial solvency of insurance companies and their policyholders. As such, many countries require direct insurance companies which wish to assume reinsurance to obtain specified authorisation to carry on their reinsurance business[164]. In addition, regulators need to pay more attention on the accepted reinsurance activities. This should include the financial solvency of the insurance companies, the type and sources of its business, its exposures to loss, its retrocession arrangements, its reinsurers, the competence of its management to manage relevant transactions, and its business control systems[165].

3. Regulation of reinsurance intermediaries

It is well accepted that reinsurance intermediaries play a vital role in many reinsurance transactions, including the placement of reinsurance, administration of the reinsurance contracts, and in some cases, the resolution of disputes between the

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[162] *See* Tal P. Piccione, *Panel on Reinsurance Regulation*, in Seventh Annual Conference of the IAIS, at 6-7 (Cape Town, 10 October 2000).
[163] *See* JOSEPH J. NORTON, *supra* note 54, at 27.
[164] *See* Peter Falush, *supra* note 6, at 266-267.
[165] *Id*, at 267.

contracting parties[166]. Consequently, reinsurance intermediaries should have a duty to ensure the quality of reinsurance transactions and the disclosure of material facts to prevent any legal dispute arising from the contractual reinsurance wording. Due to the broad spectrum of the reinsurance intermediaries' responsibilities and the potential for credit risk, error and fraud, the US and UK models have developed substantial regulations to regulate the activities of reinsurance intermediaries[167]. However, reinsurance intermediaries can carry on activities without any authorisation in Taiwan. Therefore, the Taiwanese government should consider and enact appropriate regulations as to reinsurance intermediaries.

[166] *See* Debra J. Hall, *supra* note 116, at 859-860.
[167] *See id.* at 860-861.

Chapter Two

Regulation of Reinsurers and the Reinsurance Arrangements of the Primary Insurers: Regulatory Reform in Emerging Economies

As generally discussed in the Chapter One, various international trends can be discerned as significant impacting on current worldwide efforts, particularly in emerging market, to effect viable reinsurance regulatory reform. As the efforts have already been made to liberalise reinsurance business and to harmonise the insurance regulation by international organisations, *e.g.*, WTO/GATS, OECD, and IAIS[1], the development of an appropriate reinsurance regulatory regime is becoming an increasingly essential issue for emerging market in order to enhance the stability of insurance market. In this context, this chapter will address the main issue of the regulation of reinsurers and the supervision of reinsurance arrangements of primary insurers, with a view to considering an appropriate model to maintain the solvency of primary insurers. In doing so, this chapter will attempt to lay out what appears to be the general issue relating to regulation of reinsurers and primary insurers' reinsurance arrangements.

As a result of the indirect relationship between reinsurers and the insured party, it appears that the regulation of reinsurance varies in many aspects from the regulation of the primary insurers, particularly with regard to market conduct regulation including the tariff and reinsurance contracts. As stated in Chapter One, regulation of reinsurance has been reduced or even eliminated in most countries[2]. Since insurance regulation generally is based on the protection of policyholders[3], emphasis has been given to the protection of the solvency of primary insurers in some

[1] *See generally* the discussion in Chapter One.

[2] *See* WERNER PFENNIGSTORF, PUBLIC LAW OF INSURANCE, INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW VOL.6 COMMERCIAL TRANSACTIONS AND INSTITUTIONS CHAPTER 7, 43 (Martinus Nijhoff Publishers, 1998).

[3] For example, in the reinsurance markets in the economies in transition, "reinsurance regulation has not received much attention partly because of the absent of significant domestic reinsurance activity and partly due to the absent of a reinsurance regulatory model in Europe, on which much of insurance regulation in economies in transition are based." Peter Falush, *The Development Of Reinsurance Markets In The Economies In Transition*, in Insurance Regulation and Supervision in Economies in Transition: Second East-West Conference on Insurance Systems in Economies in Transition, OECD Proceedings 239 (Organisation for Economic Co-operation and Development 1997).

countries such as the United States[4]. This emphasis is justified by the fact that several significant cases of insolvency relating to primary insurers result from unrecoverable reinsurance[5]. This might lead to the view that the main purpose of the regulation of reinsurers is to ensure the security of reinsurance arrangements and the recoverability of reinsurance. However, in the other countries[6], the reinsurers are treated similarly to the primary insurers and are subjected to relevant solvency regulation and investment regulation. Generally, the structure of the regulation of reinsurance will depend on the market characteristic and regulatory environments.

In emerging markets, the main concern of primary insurers and regulators is to transfer risk and to extend domestic capacity[7]. As a result of a shortage of capital capacity to cover assumed risk, it is essential to avoid any unnecessary operational obstacles arising from relevant regulation that may impede the diversification of insurance risk. Liberalisation of reinsurance transactions will result in dramatic increase in cross-border transactions. Consequently, it may impede the capacity of regulators to supervise and regulate when reinsurers are licensed and regulated in another jurisdiction, in which financial information on reinsurers may be difficult to obtain. Regulators are likely to become unable to ensure the solvency of reinsurers[8]. Under such a scenario, regulators in emerging markets might face the difficulty of reconciling between liberalisation of reinsurance transactions and guaranteeing financial solvency of primary insurers. Furthermore, it is unlikely to find many domestic reinsurers accepting risk from primary insurers that are licensed within the same jurisdiction. As a matter of fact, primary insurers in emerging markets rely on

[4] For instance, NAIC Model Law on Credit for Reinsurance in the US provides the condition which primary insurers should take credit from reinsurance for technical reserve. NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (N. A. I. C.), *Reinsurance: Credit for Reinsurance Model Law*, in NAIC MODEL LAWS, REGULATIONS AND GUIDELINES VOL.V, 785 (1999).

[5] *See generally* the discussion in Chapter One.

[6] Although the reinsurers in the United Kingdom are subject to the similar solvency regulation as the primary insurers, the reinsurers who only carry on the reinsurance business is relative less regulated. For detail, *See* chapter 1 the structure of reinsurance regulation, the UK model.

[7] It has been recognised that "the primary role of reinsurers is to provide adequate coverage of insurance risk. There should be no rules or limitations or international capital transfers for foreign and domestic reinsurers" during the Annual Conference of the IAIS, in Cancun, Mexico, in September 1998. *See* IAIS Working Group on Reinsurance, *Reinsurance and Reinsurers: Relevant Issues for Establishing General Supervisory Principles, Standards and Practices*, at 11 (Feb. 2000), available at <www.iaisweb.org>

[8] *See* Jonathan Spencer, *Cross-border Services Regulation*, in GLOBAL REINSURANCE, September/November 1995, at 76 (1995). However, this article points out that, while recognising the

either state-owned reinsurers or foreign reinsurers to assume their insured risk. Thus, more attention should be given to reinsurance arrangements of primary insurers instead of simply imposing stricter regulation on reinsurers.

In terms of the regulation of reinsurers, reinsurers are subject to similar solvency requirements as those that are imposed on primary insurers although the standard of solvency requirement for reinsurers may be less stringent in some cases[9]. Due to the dynamic character of reinsurance markets and the sophistication of contracting parties, regulation of reinsurers differs primary from the regulation of insurers with respect to market conduct regulation regarding contract terms and tariff. However, the regulators in emerging markets often encounter difficulties in obtaining information concerning foreign reinsurers who transact business with domestic insurers. In addition, it is unlikely that regulators would have the ability to ensure the financial solvency of foreign reinsurers by implementing relevant financial requirements. Therefore, it is essential to enhance cooperation amongst regulators in different jurisdictions in order to obtain the financial information and to introduce adequate regulatory methods to assess the security and the recoverability of reinsurance.

With regard to regulation of primary insurers' reinsurance arrangements, issues often arise from the financial impact caused by reinsurance arrangements on primary insurers. The extent to which reinsurance affects the solvency of primary insurers depends upon the method of calculating the technical reserve (or loss reserve) designed to meet the liability arising from the claims from the policyholders. When countries adopt the "net reserving basis", which allow primary insurers to reduce technical reserve by the amount of reinsurance arrangements[10], the recoverability of reinsurance might have a direct impact on the solvency of primary insurers. It should be noted that the amount of reduced technical reserve is not only determined by the amount of reinsurance, but also by the amount of paid reinsurance premium and the loss of investment on the reinsurance claims which should be received in a reasonable

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prudential concerns regarding the reliability of cross-border transactions, it is also important to consider the benefit these transactions can provide.

[9] For instance, in the United Kingdom, the deposit of requirement is not applicable in the case of an insurers for an authorisation restricted to reinsurance business in accordance with Insurance Company Act 1982. T. HENRY ELLIS & JAMES A. WILTSHIRE, REGULATION OF INSURANCE IN THE UNITED KINGDOM AND IRELAND B. 3.4-01 (Kluwer, Issue 63, 02/2000).

time to meet the claims[11]. As a result of the significant financial impact caused by the collection of reinsurance, some developed countries have developed relevant regulations to regulate the condition under which insurers may be able to reduce their loss reserve[12]. While it seems that these developed models have proved to be successful to ensure the stability of the insurance market, similar regulatory methods have not yet been implemented in emerging markets. In addition to the lack of prudential regulation, market characteristics and the particular legal environments has made it more difficult to design an appropriate regulatory model to maintain the stability of insurance market.

The main objective of this chapter is to develop an appropriate regulatory model for emerging market. In order to achieve this objective, this chapter will be organised as follows. Section 1 and 2 will consider the general regulatory issues relating to the scope and the implementation of reinsurance regulation. In terms of the general regulatory issues relating to regulation of reinsurers and reinsurance arrangements of primary insurers, there are two that appear to be of most significance. First, regulators need to address the questions whether reinsurers who carry on reinsurance business should be subject to direct regulation and relevant solvency regulation. Second, given the trends of liberalisation of reinsurance trade, how should regulators supervise the reinsurance arrangements of primary insurers and maintain their financial solvency? After considering these issues, international supervisory principles will also be discussed in section 3. Drawing on these models and practical considerations, this chapter will then turn to propose a number of reforms for reinsurance regulatory structures in emerging market.

I. Regulatory Issues relating to Reinsurers: Direct Supervision versus Indirect Supervision

With respect to regulation of reinsurers, it is difficult to design an appropriate regulatory structure that enables domestic insurers to benefit from the liberalisation of

[10] In contrast, the gross reserving basis is that the amount of reinsurance transferred by the insurers can not be used to reduce their loss reserve. For detail, *See generally* discussion in Chapter 1.

[11] *See* Thomas Warnke, *Reinsurance Collections: The Primary Companies' Challenge*, in Law and Practice of International Reinsurance Collections and Insolvency, held by National Institute on International Reinsurance Collections and Insolvency, at 36, (New York, June 11-12, 1988).

[12] In the United States, regulations regulate the conditions under which insurers may take credit for reinsurance in their reserves. NAIC, *supra* note 4, at 785-1. *See also* GRAYDON S. STARING, LAW OF REINSURANCE § 5:5 (1993), West Group.

reinsurance without endangering the recoverability of reinsurance. In general, regulation of reinsurers can be categorised into two regulatory approaches: *direct supervision* of reinsures and *indirect supervision* of reinsurers by way of supervision of reinsurance policies of primary insurers. In terms of *direct supervision* of reinsurers, all the reinsurers who intend to carry on reinsurance business should obtain authorisation or license from the insurance regulators. According to this approach, the reinsurers should meet the regulatory requirements in relation to corporate structure, capital requirements, financial solvency requirements, and the relevant obligation to submit their financial statements. On the other hand, *indirect supervision* of reinsurance means that insurance regulators place emphasis on the reinsurance policies of primary insurers rather than the reinsures. In the case of the indirect regulatory approach, the insurance regulators monitor and supervise reinsurance arrangements of primary insurers. In other words, the insurance regulators lay down the requirements for the approval of reinsurance arrangements of primary insurers. In most cases, this approach often provides less strict regulations for reinsurers.

In the following sub-section, these arguments will be identified and discussed.

A. Arguments for *Direct Supervision* of Reinsurers

In terms of arguing for *direct supervision* of reinsurers[13], several primary points can be made.

First, regulators may face a dilemma between the liberalisation of reinsurance transactions and the financial security of reinsurance. While trade barriers as to reinsurance have been gradually dismantled in recent years, more attention should be paid to avoid any improper sequencing of financial reform, which has been a critical factor in many financial crises[14]. In other words, an alternative regulatory system should be introduced to maintain the financial stability of insurance market. Consequently, reinsurers should be subject to similar financial requirements as primary insurers and regulators should ensure their ability to supervise these reinsurance activities. In supervising reinsurers directly, insurance regulators can effectively monitor the financial solidity of reinsurers. Furthermore, regulators can

[13] It also can be catergorised as domiciled oriented regulation that means that all the reinsurers should be licensed or authorised in which they do reinsurance business. *See* Manuel Aguilera-Verduzco, *Reinsurance Regulation and Supervision*, OECD, at 2 (20 October 2001), at <www.oecd.org>.

[14] JOSEPH J. NORTON, FINANCIAL SECTOR LAW REFORM IN EMERGING ECONOMIES 26 (London, 2000).

obtain the essential information of reinsurers; e.g., investment, capital and management requirements, and reinsurance business[15].

Second, due to reinsurance market dynamics and intense competition, reinsurers frequently engage in innovative investment instruments to diversify assumed insurance risk. As a result, regulators may encounter problems in accurately assessing the financial security of reinsurers who are exempted from domestic regulation. In *direct regulation* of reinsurers, it can offer the advantage of supervising reinsurance solvency and investment management on national basis as the case is with respect to a primary insurer.

Third, as a result of the necessity of fitness and propriety of management to keep pace with market dynamics and fierce competition, reinsurers should maintain their expertise, competence and suitability. In terms of governmental supervision concerning the competence and fitness of key personnel, a licensing or authorising procedure incorporated in the regulatory regime can ensure licensed or authorised reinsurers to carry on reinsurance business with integrity, prudence and the appropriate degree of professional competence. Therefore, it is essential to implement direct regulation of reinsurers to ensure the professionalism and appropriateness of the representatives of the reinsurance companies.

B. Arguments against *Direct Supervision* of Reinsurers

There are essentially three fundamental categories of arguments against *direct supervision* of reinsurers: (i) liberalisation of reinsurance business and diversification of insurance risk; (ii) systemic risk and reinsurance business; (iii) an alternative regulatory approach to maintain the stability of insurance market.

1. Liberalisation of insurance business and diversification of insurance risk

First, as the direct supervision of reinsurers could impose entry requirements on reinsurers who intend to carry on reinsurance business in the domestic market, it may impede the liberalisation of reinsurance transactions and increase transaction costs. In addition, it is likely that reinsurers who are licensed and supervised by the relevant solvency regulation should localise their capital and investment in the local market. Consequently, strict investment regulation may have adverse effect on the

[15] IAIS Working Group on Reinsurance, *supra* note 7, at 49.

diversification of insurance risk. Given that funds held relating to catastrophe risk (e.g., earthquake and hurricane) should not be affected by the occurrence of the event[16], reinsurers may fail to diversify these risks by ways of investing funds abroad due to relevant restrictive regulations. Furthermore, it is argued that "high barrier to entry and restrictive practices in certain countries prevents free competition between reinsurers and has the effect of keeping prices in those countries artificially high"[17]. Such a domicile oriented regulatory approach tends to be used only in countries with high retention levels of premium[18] or developed countries such as the United Kingdom.

2. Systemic risk and reinsurance business

Second, from the viewpoint of systemic risk and the stability of financial market, it has been observed that "it is unlikely that the reinsurance industry can be linked to systemic problems of financial instability.[19]" The reasons for this conclusion are as follows. "(1) Relative magnitude of reinsurance; (2) Major reinsurers are neither subsidiaries of large bank holding companies nor owners of large banks; (3) Shift from proportional to non-proportional reinsurance programs; (4) Reduction in cession rates; (5) Industry stability; (6) Creditable rating system; (7) Limited importance of regulatory arbitrage; (8) Time lag between the occurrence of an event and the payment of claims; (9) Relative insignificance of alternative risk transfer products.[20]" Given that systemic risk caused by the reinsurance industry seems low, it has been argued that "over-restrictive investment rules imposed to prevent insolvencies may not only be inefficient but also counterproductive."[21] Therefore, strict *direct*

[16] John H. Fitzpatrick, *Comments on Stephen Ross's Paper on Financial Regulation for the New Millennium: The Case for Liberal Reinsurance Regulation*, THE GENEVA PAPERS ON RISK AND INSURANCE, Vol. 26 No. 1, at 26 (The International Association for the Study of Insurance Economics, January 2001).

[17] *See* Michael Pickel, *Panel On Reinsurance Regulation: The Importance Of Global Regulation of Reinsurers Seen From The Point Of View Of A German Reinsurer*, in Seventh Annual Conference of The IAIS, at 3 (Cape Town, 10 October 2000). In addition, as a result of characteristics of the insurance market, insurance companies are generally not subject to a run as the banking industry. *See also* John H. Fitzpatrick, *supra* note 16, at 24.

[18] *See* Manuel Aguilera-Verduzco, *supra* note 13, at 2.

[19] *See* Michael Hafeman, *Work of the Financial Stability Forum-Working Group on Offshore Centres on Reinsurance*, at the Seventh Annual Conference of the IAIS, at 8 (Cape Town, 10 October 2000).

[20] *Id.* at 9-10.

[21] John H. Fitzpatrick, *supra* note 16, at 24.

regulation imposed on reinsurers "would prevent reinsurers from performing many of their core functions and threaten the economic benefits associated with reinsurance."[22]

3. An alternative regulatory approach to maintain the stability of insurance market

The final argument is that the regulatory purpose of ensuring the stability of insurance market can still be achieved even without the prudential regulation to supervise reinsurers directly. This alternative regulatory approach is based on harmonisation of regulatory methods and mutual recognition among countries where reinsurers are already subject to prudential regulation and have sound financial condition. In essence, regulators place their emphasis on the reinsurance arrangements of primary insurers to control the quality of reinsurance with respect to financial solvency of reinsurers and the reinsurance contracts. To ensure the quality of reinsurance, regulators can authorise or accredit foreign reinsurers to carry on business if these reinsurers are licensed and regulated in the jurisdiction where there is a similar solvency regulation. As a result, harmonisation of relevant regulation is the first step to provide the level playing field for reinsurers and avoid regulatory arbitrage. Consequently, mutual recognition can be used as a tool to promote cooperation between countries and to reduce any unnecessary regulatory costs. In doing so, regulators not only can promote the diversification of domestic risks but also can prevent financial impact arising from insolvent reinsurers and irrecoverable reinsurance. Given the above assumption, it was suggested that "a harmonised single licensing system for reinsurance activities, that is similar to the current model of insurance supervision in the European Union, is the ideal to work towards.[23]" Therefore, such a regulatory approach can reduce the uncertainty of financial stability of reinsurance market in the absence of direct regulation of reinsurers.

C. Summary Observation: Some Preliminary Requirements for a Viable Indirect Supervisory Approach

Liberalisation and internationalization of reinsurance transactions provide emerging markets with the opportunity to extend capital capacity to underwrite risks; to enhance the expertise and competence of primary insurers; to diversify risks internationally; and generally, would contribute a stable growth of insurance market. As liberalization

[22] *Id.* at 25.

of reinsurance business may benefit emerging markets, the regulatory reform to develop an appropriate regulatory system is crucial to maintain the financial solvency of primary insurers.

In essence, the financial condition of reinsurers is the main concern for regulators and primary insurers. However, regulators would face a dilemma between strict *direct regulation* of reinsurers and freedom of reinsurance transactions. In supervising reinsurers directly, regulators can efficiently monitor reinsurers and primary insurers can assess the quality of reinsurance accurately. By contrast, *direct regulation* of reinsurers may have adverse impact on the reinsurance business and may impede the diversification of insurance risks. As an alternative regulatory approach that can ensure the stability of insurance market, it appears that *indirect regulation* of reinsurers would be more appropriate for emerging markets to adopt.

However, the indirect regulatory approach to regulating reinsurers may have some flaws if the following aspects have not been considered.

First, as a fundamental and evident precondition, reinsurers should be licensed and subject to prudential regulation in the countries of domicile. This is due to the fact that indirect regulation as an alternative regulatory approach is based on the mutual recognition. In addition, regulators should promote cooperation among countries and gather sufficient information to assess reinsurers.

Second, such a regulatory system should be harmonized and based on prudential regulatory standards. One of the arguments against *direct supervision* of reinsurers suggested that "there is no justification to increase reinsurance regulation for the purpose of securing the stability of the financial market.[24]" This observation is generally based on the stability of the current reinsurance market and the low systemic risk (or liquidity crisis) caused by an insolvency of reinsurer[25]. Noted, however, that as a result of the trend towards concentration in reinsurance market[26], the financial impact caused by these major reinsurers is becoming significant. Consequently, an appropriate governmental supervision of reinsurers is essential to review capital adequacy, solvency and professional competence of reinsurers. This

[23] *See* IAIS-Working Group on Reinsurance, *supra* note 7, at 6.
[24] *See* Michael Pickel, *supra* note 17, at 4.
[25] *Id.* at 3-4.
[26] *See* A. J. Vermaat, *A Supervisor's View on Reinsurance*, IAIS, at 4 (15 November 2001), at <www.iaisweb.org>.

will also benefit primary insurers in assessing the reinsurers accurately. An indirect regulation model will be successful only if it is properly structured and if it takes into account the supervision of foreign reinsurers who are already subject to similar regulatory requirements.

Third, given that harmonization of reinsurance regulation would contribute to the stability of global insurance market and to the evaluation of the security/creditworthiness of reinsurers, the regulatory standards accepted by countries that intend to enhance international regulatory cooperation should not be set at the lowest common denominator. Although "harmonization" of regulatory approaches may reduce regulatory costs such as the single license concept in the European Union, a negative effect may occur in countries which already have more sophisticated systems of solvency regulation. It is inevitable that regulatory arbitrage would occur when the harmonization of regulatory standards is not based on the highest common denominator[27]. As a result, the acceptable regulatory standards for the global reinsurance market should not be established at the minimum regulatory requirements if they are to provide a level playing field for reinsurers.

II. Selective Issues relating to Regulation of Reinsurance Arrangements of Primary Insurers

In terms of solvency regulation for insurance enterprises, regulation generally concerns three aspects, namely technical reserve, solvency margin, and valuation of assets[28]. The extent to which reinsurance may affect the solvency of primary insurers depends on the place of reinsurance in the method of accounting. In general, regulators may consider reinsurance either "in the framework of accounting (valuation of receivables, deposit of the reinsurer's part of liabilities), or in the framework of solvency requirements (taking into account only a limited part of ceded business to

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[27] It has been observed that many in the U.S. fear that the mutual recognition approach "may result in regulation at the level of the lowest common denominator." Debra J. Hall, *Reinsurance Regulation in a Global Marketplace: A View from the United States*, Reinsurance Association of America, at 11, (12 Dec. 2001), at<http://www.raanet.org/policyupdate/Marketplace.PDF.>

[28] Technical reserve is designed to ensure that an insurer has a sufficient fund to meet the liability arising from accepted insurance business. In addition to technical reserve requirements that ensure the ability of an insurer to cover the existing liability, the solvency margin is to ensure that an insurer has adequate funds to cover the future writings. When the funds can be invested and held by several different investment instruments (e.g. securities, bank deposit, and large property holdings), it is also essential to evaluate the actual value of assets held by an insurer. *See generally* ROBERT KILN & STEPHEN KILN, REINSURANCE IN PRACTICE 385-397 (4th ed. 2001).

reduce the required margin or required free capital in proportion of reinsurance receivables).[29]" In the European Union, some member states may allow reinsurance in reduction of required solvency margin, but the reduction must not exceed a specified percent of required solvency margin[30]. However, other member states adopt the gross technical reserving basis and only allow the reduction of required solvency margin "if a corresponding deposit of premium is made as security for future claims on the reinsurance."[31] In the United States, the amount of technical provisions can be reduced by the amount of reinsurance that meets the relevant requirements such as evidence of risk transfer[32], licensed and accredited reinsurers, or the certain amount of security held[33]. Although regulatory approaches vary in the methods to count reinsurance, to evaluate the creditworthiness of reinsurers is the most essential component in these regulatory approaches.

In this section, emphasis will be placed on the assessment of the creditworthiness of reinsurers and the implementation of relevant solvency regulation. As reinsurance should be considered to secure primary insurer's financial stability, possible preventive measures which may be supported or even required by a regulatory framework will be examined.

As the regulation concerning primary insurers' reinsurance arrangements generally gives emphasis to the security of reinsurance, the relevant issues relating to insolvency of insurers have drawn significant attention in some countries. In the event of insurer's insolvency, legal disputes often arose from the reinsurance payment of the reinsurer. As a result of possible effect on the interests of policyholders, this will also be discussed in the following sections.

In addition to governmental supervision, corporate governance and internal controls can be used as a tool to ensure that the primary insurers would arrange

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[29] *See* IAIS, On Solvency, Assessment and Actuarial Issues-An IAIS Issues Paper (Final Version), at 15 (20 October 2001), at <www.iaisweb.org/framesets/pub.html>.
[30] For example, the reduction must not exceed 50 per cent for non-life insurance and 15 per cent for life insurance. *See id.* at 26.
[31] In France, the ceding insurers cannot reduce their technical reserve only if the certain amount of reserve is made as a deposit for future reinsurance claims. *See id.* at 26.
[32] NAIC, Chapter 22 of the Property/Casualty Accounting Practices and Procedures Manual for Statutory Accounting, in COOPERS & LYBRAND LLP., A SUPPLEMENT TO IMPLEMENTING FASB STATEMENT 113- A MANAGEMENT GUIDE 38 (London, January 1996).
[33] *E.g.*, Del. Code Ann. Tit. 18, §910 (1989); Me. Rev. Stat. Ann. Tit. 24A, §731(1990); Mo. Rev. Stat. § 375.246 (1968); N.Y. Ins. Law § 1308 (McKinney 1985). Cal. Ins. Code §§ 922.4, 922.5 (West 1993). Cited by GRAYDON S. STARING, *supra* note 12, §5:5.

reinsurance prudentially. The relevant requirements for corporate governance and internal control will also be discussed in this section.

A. Creditworthiness and Security of Reinsurance- the Implementation of Relevant Solvency Regulation

In terms of creditworthiness and security of reinsurance, two fundamental regulatory issues emerge. First, it is difficult for supervisors to establish an appropriate assessment to evaluate the security of reinsurance. Second, it is also problematic to establish a regulatory framework concerning the evaluation of reinsurers.

With respect to the assessment of security of reinsurance and creditworthiness of reinsurers, it can be analysed into the following aspects; (1) Fitness and Propriety of Management; (2) Legal Disputes and Payment Issues; (3) Financial Solvency and Capital Adequacy; (4) The Domiciled Regulatory System.

As the creditworthiness of reinsurance can be evaluated and monitored, it is crucial to consider a viable solvency regulation concerning the reinsurance. In the following section, some developed models will be introduced and discussed.

1. Assessment of security of reinsurance and creditworthiness of reinsurers

Following on the discussion relating to the indirect regulatory model, *indirect supervision* of reinsurance considers possible regulatory approaches to control the creditworthiness of reinsurance and to monitor the financial condition of reinsurers. As such an indirect regulatory model not only can reduce the scope of regulation[34] but it can also ensure the security of reinsurance and maintain the stability of insurance market, it can offer an appropriate regulatory regime for emerging markets with their shortage of capital capacity and expertise. In the following section, several essential components will be identified to establish a viable assessment to evaluate the creditworthiness of reinsurance.

a. Fitness and propriety of management and the performance of reinsurers

The quality and integrity of management plays a crucial role in the evaluation of the security of reinsurance. From the viewpoint of ceding insurers, the competence, experience and integrity of key personnel (e.g., board management, legal

[34] Manuel Aguilera-Verduzco, *supra* note 13, at 3.

representatives[35], and principal shareholders.) in the reinsurance company might significantly affect the quality of reinsurance and provide relevant expertise to assist ceding insurers. For reinsurers, the competence and experience of key personnel are vital to manage underwriting risk[36] and operation risk. Furthermore, a sound risk management and prudent investment, which is essential to maintain financial solvency of a financial institution, is generally determined by the quality and propriety of management. In addition to competence and experience of key personnel, special attention should be paid to a person's past record relating to criminal or civil sentences or convictions[37]. Besides, the performance of a reinsurance company should be considered in the framework of the assessment. In terms of performance indicators, it has been suggested that the following aspects can be used as the performance indicators for the assessment of reinsurers: "(1) Gross and net premiums; (2) incurred losses (gross and net); (3) operation expenses; (4) investment income"[38].

b. Legal disputes and payment issues

While the issues concerning fitness and propriety of management and the key personnel in a reinsurance company has been addressed, the problems arising from legal disputes between reinsurers and ceding insurers needs to be discussed. Legal disputes "can arise from differences in interpretation of the contract, notice, performance and ultimately the amount recoverable.[39]" Historically, reinsurance practice regarding the partnership relation between reinsurers and primary insurers was based on utmost good faith. This approach was capable of resolving short-term legal disputes. It proved, however, insufficient when certain circumstances changed, such as unwillingness of one party to accommodate the other in long-term partnership

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[35] OECD, RECOMMENDATION OF THE COUNCIL OF ASSESSMENT OF REINSURANCE COMPANIES, adopted by the Council at its 921st Session on 25 March 1998 (C/M (98) 7/PROV), at 4 (19 October 2001), at<www.oecd.org>. *See also* ROBERT KILN & STEPHEN KILN, *supra* note 28, at 396.

[36] It has been observed that "the best and safest reinsurer is one whose past record on underwriting is consistently profitable." ROBERT KILN & STEPHEN KILN, *supra* note 28, at 396.

[37] OECD, RECOMMENDATION OF THE COUNCIL OF ASSESSMENT OF REINSURANCE COMPANIES, *supra* note 35, at 4.

[38] With regard to premiums and losses, it should obtain the information regarding "the main classes of covered risks; and at least for general liability, transport and catastrophic risks; and the main countries or regional group of countries, in which they operate." Consequently, these data should enable "the calculation of combined ratio (losses plus expenses divided by premiums), loss ratio, expense ratio, operation ratio (losses plus expense minus investment income divided by premiums) and retention ratio." It also should consider the security of retrocession. *Id.* at 4-5.

[39] Thomas Warnke, *supra* note 11 at 43.

or in cases of losses beyond the expectations[40]. Consequently, the reinsurers may delay or avoid payment and hence the financial impact on the primary insurers. With respect to general reinsurance claim disputes, it has been categorised as follows: (1) "Defenses against the existence of the reinsurance contract, including nondisclosure and misrepresentation issues[41]; (2) Reporting and notice defenses[42]; (3) Defenses arising from application of the reinsurance contract wording to the indemnity paid[43]; (4) Cooperation and claim-handling defenses[44]; (5) Public policy defenses[45]". As a result of increasing legal disputes between reinsurers and primary insurers, the reinsurance contract should be carefully drafted. From the viewpoint of a ceding insurers, a reinsurer's past record and reputation on the reinsurance payment should also be considered.

In addition to legal disputes, primary insurers should collect their reinsurance efficiently and avoid uncollectible reinsurance. Due to the financial impact arising from delayed reinsurance recoverable, some developed models have certain statutory accounting treatments designed to reflect the recoverability of reinsurance claims. For instance, the NAIC created the 90-day rule to require primary insurers to collect their reinsurance recoveries in a timely manner[46]. The rules imposed the penalty on a primary insurer to "reduce surplus by an amount equal to 20 percent of all

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[40] For instance, in the early 1980s, long-tail business in liability insurance. *See id.* at 46.

[41] In the English courts, the following cases are related to misrepresentation and non-disclosure. *Pan Atlantic v. Pine Top* [1992] 1 Lloyd's Rep 101: "If the underwriter who actually wrote the risk was not influenced by the mispresentation or non-disclosure, he cannot avoid the contract." For other cases concerning the mispresentation and non-disclosure, *GMA v. Storebrand and Kansa* [1995] LRLR 33; also *See PCW Syndicates v. PCW Reinsurers* [1996] 1 Lloyd's Rep 241. cited in Iain Goldrein, *Won't Pay-Reinsurers' Defences To Claims*, in Reinsurance Recoveries, held by Hawksmere, at 6-14 (The Sheraton Park Tower, London, 1 October 1998). For the US cases, *CAN Reinsurance of London v. Home Insurance Company* No. 85 Civ. 5681 (JFK), WL 3231 (S.D.N.Y. Jan 10, 1990) (relating to mispresentation); *American Re-Insurance Company v. MGIC Investment Corporation* No. 77 CH 1457 (III. Cir. Ct. Cook City., Chanc. Div., Oct. 20, 1987) (relating to innocent misrepresentation); *American Home Assurance Company v. Fremont Indemnity Company* 745 F. Supp. 974 (S.D.N.Y. 1990) (relating to materiality). *See generally* ROBERT W. HAMMESFAHR & SCOTT W. WRIGHT, THE LAW OF REINSURANCE CLAIMS 72-90 (Reactions Publishing Group, 1994).

[42] *Unigrad Security Insurance Company, Inc. v. North River Insurance Company* No. 91-7534 (2d Cir., Sept. 9, 1993), 4 Mealey's Reins. Rep., No. 9, A-1 (relating to the notice of loss).

[43] For example, the legal disputes often arose from liability insurance and relevant pollution insurance. *Insurance Company of North America v. Forty-Eight Insulations*, Inc. 633 F. 2d 121 (1980), reh'g granted, in part, clarified, 657 F. 2d 814 (6th Cir. 1981) (relating to asbestos claims and exposure theory for trigger of coverage). cited by ROBERT W. HAMMESFAHR & SCOTT W. WRIGHT, *supra* note 41, at 169.

[44] In the US court, *Peerless Insurance Company v. Inland Mutual Insurance Company* 251 F. 2d 696 (4th Cir. 1958) (cooperation relating to a claim). For the English court, *Welch v. Royal Exchange Assurance* [1939] 1 KB 294.

[45] ROBERT W. HAMMESFAHR & SCOTT W. WRIGHT, *supra* note 41, at 4.

[46] Schedule F, Parts 1 to 8, the NAIC annual statement. *See generally id.* at 248-251.

recoverables due from the slow-paying reinsurer" if reinsurance recoverables are not received by year-end and are 90 days overdue[47]. To avoid such a penalty, the ceding insurer must draw down letters of credit or other collateral for amount owed by reinsurers even though collateral is required for ceding insurers in the event of ceding business to unauthorised and non-U.S. reinsurers[48]. However, as for disputed reinsurance claims, the 90-day rules permit a primary insurer to avoid such a penalty if a reinsurer "issues a reservation of its rights, refuses to pay, or initates litigation or arbitration"[49]. Although such a regulatory approach may provide an incentive to increase the claims efficiency, adverse effects may occur and legal uncertainty may increase in case of ambiguity of the relevant regulation (e.g, the definition of disputes and when the claims are considered due)[50].

c. Financial condition of reinsurers

A sound financial condition of reinsurer plays an important role in the recoverability of reinsurance. In addition, reinsurers, like other financial intermediaries (e.g., Bank, and insurance companies), may cause systemic risks particularly following the trend of consolidation and convergence of financial markets. As a result, it is crucial to address the essential elements which may affect the financial solvency of reinsurers. In general, financial solvency of reinsurers who assume risk from insurance companies can be evaluated in similar manner as those applied to primary insurers. As for the solvency rules for insurers and reinsurers, a reinsurer's solvency relies on at least the following three aspects.

" (1) a prudential evaluation of the technical provisions;

(2) the investment of assets corresponding to these technical provisions in accordance with quantitative and qualitative rules;

(3) the existence of an adequacy solvency margin[51]".

First, technical provisions are designed to ensure the financial ability of reinsurers or insurers to meet any possible liabilities arising from insurance or

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[47] *Id.* at 248-249.

[48] This is because the ceding companies may not have drawn down collateral as contemplated. *See id.* at 250.

[49] *Id.* at 251 (1994). *See also* Property and Casualty Annual Statement Instructions, National Association of Insurance Commissioners 53-1 (revised P/C 1993).

[50] For instance, it has been criticised that such a rule cannot consider the difficulties arising from complex claims. ROBERT W. HAMMESFAHR & SCOTT W. WRIGHT, *supra* note 41, at 249-251.

reinsurance contracts. Technical provisions generally comprise two main components; claims provisions and unearned premium provisions[52]. With regard to claims provisions, it includes outstanding liability provisions, future loss expense, future claims handling expense, and incurred but not reported claims (also known as I.B.N.R.)[53]. It should be noted that reinsurers might encounter certain loss situation where there is little or no pattern of past settlements to calculate an appropriate amount of loss provisions (e.g., a major catastrophe, and legal liability relating to pollution and asbestos)[54]. As a result of the significant impact caused by these risks, it has been suggested that provisions for special cases should be considered and should be maintained to meet the claims in the event of a catastrophe or long-tail business[55].

Second, the investment[56] of reinsurance companies' assets shall be prudential and the assets shall be valued properly. The primary insurers should gather accurate information relating to reinsurers' investment and evaluate the "security and profitability[57]" of these investments. It has been recommended that primary insurers should take all appropriate steps to assess the soundness of the investments of reinsurance companies in the following respects[58]. A primary insurer can evaluate the reinsurers' assets in several categories: real estate, mortgage loans, shares, bonds with fixed revenue, loan other than mortgage loans, other investments. As the use of financial derivatives as a management instrument may prove useful and effective if their use is consistent with appropriate and prudential management such as currency matching[59], the assessment should take into account the relevant investment instruments.

Third, solvency margins of reinsurers should be assessed accurately. In terms

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[51] IAIS Sub-Committee, *supra* note 29, at 7.
[52] ROBERT KILN & STEPHEN KILN, *supra* note 28, at 397-401.
[53] *Id.* at 398.
[54] *Id.*at 400-401.
[55] *Id.* at 401. As for long-tail business, it also has been considered in the EU solvency regulation. "The additional measures of long-tail risks have been on the agenda, as have the question of refined risk classification." IAIS Sub-Committee, *supra* note 29, at 27.
[56] The source of investable fund comprises capital based fund and technical provisions based fund which is generated by the business written.
[57] OECD, *Selected Principles for the Regulation of Investments by Insurance Companies and Pension Funds*, in FINANCIAL MARKET TRENDS, no. 75, at 117 (March 2000), (9 Jan. 2002) at <http://www.oecd.org/pdf/M00015000/M00015497.pdf>.
[58] OECD, RECOMMENDATION OF THE COUNCIL OF ASSESSMENT OF REINSURANCE COMPANIES, *supra* note 35, at 4.

of solvency margin, reinsurers should have sufficient funds (surplus) to support the future writings[60] and allow a margin for possible misrepresentation in the valuation of assets due to external factors (e.g., fluctuation in currency exchange[61]). The solvency margin also can be described as a more technical definition as follows:

"Solvency Margin (surplus capital) of an insurance company is the surplus of assets over liabilities, both evaluated in accordance with regulations of public accounting or special supervisory rules.[62]"

As a result of varying evaluation of solvency margin among countries, it should consider the domiciled solvency regulation to determine and analyse the financial solvency of a reinsurer. For instance, the solvency regime used in the European Economic Area (EEA)[63] consists of two parts: (1) Required solvency margin and (2) Guarantee fund. Required solvency margin, called minimum solvency margin, uses fractions of some measure of risk exposure. For a non-life insurer, the required solvency margin is determined on the basis either of the annual amount of premium or of the average twelve-month claims during the past three financial years[64]. For a life insurance, the required solvency margin is determined on the mathematical provisions and sums at risk[65]. In relation to guarantee fund, the main purpose is to reinforce the minimum solvency margin in the event of inadequacy. An insurer should maintain its guarantee fund at a level corresponding to the higher of either one-third of the figure arrived at for the required margin of solvency or at a fixed amount depending on the classes of business written (also called as minimum guarantee fund)[66].

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[59] As a result of internationalisation of reinsurance business, a reinsurer are not handled in one single currency. How to reduce risk in currency matching is one of main issues in reinsurers' investement policy.

[60] ROBERT KILN & STEPHEN KILN, *supra* note 28, at 387.

[61] JOHN MCLEAN, CLIVE O'CONNELL, CHRISTOPHER PAINE, JOHN PAINE, & PERTER WEDGE, THE APPLICATION OF REINSURANCE, Study Course 825, at 1/4 (The Chartered Insurance Institute, 2000).

[62] IAIS Sub-Committee, *supra* note 29, at 7.

[63] The EEA consists of the 15 European Union (EU) member states, in addition to Iceland and Liechtenstein and Norway.

[64] *See* First Direct Non-Life Insurance Directive, 73/239/EEC, art. 16, 1973 O.J. (L.228/3). JOHN MCLEAN, CLIVE O'CONNELL, CHRISTOPHER PAINE, JOHN PAINE, & PERTER WEDGE, , *supra* note 61, at 7/14. ; *See also* IAIS Sub-Committee, *supra* note 29, at 25.

[65] *See* First Direct Life Insurance Directive, 79/267/EEC, art. 19, 1979 O.J. (L. 63/1). *See also* IAIS Sub-Committee, *supra* note 29, at 25.

[66] *See* First Direct Non-life Insurance Directive, art. 17, 1973 O.J. (L.228/3); and First Direct Life Insurance Directive, art 20, 1979 O.J. (L. 63/1). IAIS Sub-Committee, , *supra* note 29, at 25. *See aslo*

d. The domiciled regulatory system

To determine the creditworthiness of reinsurers particularly for a foreign reinsurer, a primary insurer and an insurance regulator generally rely on the essential information gathered from the domiciled or licensed countries (e.g., corporate structure, size and the performance). In the US regulatory regime, the Nonadmitted Insurers Information Office was created to compile information on insurers and reinsurers domiciled abroad and provided adequate information for state regulators to evaluate the financial condition of foreign reinsurers[67]. Note, however, that for emerging markets, it is unlikely that insurance regulators have adequate expertise to establish a similar institution to evaluate foreign reinsurers. Furthermore, it may increase extreme financial burden on the insurance regulatory system. As a result, the alternative approach would be to rely on private rating agencies and to enhance international supervisory cooperation.

While private rating agencies have been frequently used to assess the security of reinsurers in many countries, international supervisory cooperation relating to reinsurance business has not been emphasised by international organisations until recent years (*e.g,* IAIS)[68]. Although efforts have already been taken to facilitate international supervisory cooperation by some international orgainisations, it seems that the international supervisory cooperation in the insurance sector appears less developed than the bank's international supervisory cooperations (e.g., The Basel Committee[69]).

JOHN MCLEAN, CLIVE O'CONNELL, CHRISTOPHER PAINE, JOHN PAINE, & PERTER WEDGE, *supra* note 61, at 7/14.

[67] To facilitate the assessment and the comparison of foreign reinsurers, the financial results of the foreign reinsurers will be converted from its domestic currency to U.S. currency. *See* MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON & PETER R. KENSICKI, PRINCIPLES OF REINSURANCE VOL.2, at 214-215 (Insurance Institute of America, Pennsylvania, 2nd edition, 1995).

[68] With regard to reinsurance business and international supervisory cooperation, Insurance Code Principles established by international Association of Insurance Supervisors only stated that "The insurance supervisor should set requirements with respect to reinsurance contracts or reinsurance companies adressing- b. the amount of reliance placed on the insurance supervisor of the reinsurance business of a company which is incorporated in another jurisdiction." *See* INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, INSURANCE CORE PRINCIPLES, at 10 (October 2000), (09 October 2001), at www.iaisweb.org.

[69] *See* COMMITTEE ON BANKING REGULATIONS AND SUPERVISORY PRACTICES, BASLE CONCORDAT ON PRINCIPLES FOR THE SUPERVISION OF BANK'S FOREIGN (1975); COMMITTEE ON BANKING REGULATIONS ON SUPERVISORY PRACTICES, REVISED BASLE CONCORDAT ON PRINCIPLES FOR THE SUPERVISION OF BANK'S

In addition, gathering information to evaluate the financial condition of reinsurers, political risk and domestic laws might cause collection problems and therefore should be taken into account. It has been observed that some insurers domiciled in countries that have gone through political and economic turmoil have been unable to meet the obligations under reinsurance contracts[70].

2. Possible regulatory approaches concerning creditworthiness of reinsurers

In terms of solvency regulation, solvency margin[71], which is surplus of assets over liability, both evaluated in accordance with domestic solvency regulation, is the main component to assess the financial condition of an insurer. As the amount of reinsurance may be used to reduce the required technical provisions (or loss reserve) designed to meet the claims from the policyholders, the regulatory approaches concerning creditworthiness of reinsurers generally are considered into the framework of solvency regulation.

Regulatory approaches concerning security of reinsurance can be divided into two categories. First, the amount of reinsurance may be allowed to reduce the required technical reserve and consequently increase the policyholder's surplus. On this basis, insurance supervisors could impose relevant requirements to secure credibility of financial statements of a primary insurer who transacts with an authorised or accredited reinsurer. Second, insurance supervisors may control the

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FOREIGN ESTABLISHMENT 2 (May 1983). BASLE COMMITTEE ON BANKING SUPERVISION, INFORMATION FLOWS BETWEEN BANKING SUPERVISORY AUTHORITIES 8 (April 1990); BASLE COMMITTEE ON BANKING SUPERVISION, MINIMUM STANDARDS FOR THE SUPERVISION OF INTERNATIONAL BANKING GROUPS AND THEIR CROSS-BORDER ESTABLISHMENTS (July 1992). BASLE COMMITTEE ON BANKING SUPERVISION AND OFFSHORE GROUP OF BANKING SUPERVISORS, THE SUPERVISION OF CROSS-BORDER BANKING (Oct. 1996); BASLE COMMITTEE ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION (Sept. 1997).

[70] In some countries, the governmental control on currency exchange may impose restriction on reinsurance payment. "In the main the reinsurers in question emanate from South America but to a lesser extent companies will be found in this situation in the Middle and Far East and even in Europe in countries such as, Greece and Spain." Ivor Kiverstein, *Techniques of Reinsurance Collection*, in Law and Practice of International Reinsurance Collections and Insolvency, held by National Institute on International Reinsurance Collections and Insolvency, at 90-91 (June 11-12, 1988, New York).

[71] As a result of varying forms of solvency regulation in different jurisdictions, required solvency margin also has been referred as "available solvency margin, actual solvency margin, statutory solvency margin, available surplus capital, eligible capital, regulatory capital, free capital, total adjusted capital, policyholder surplus, and statutory surplus". IAIS Sub-Committee, , *supra* note 29, at 42.

amount of reinsurance by the required solvency margin. In other words, the amount of reinsurance could be taken into account only as a limited part of ceded business to reduce the required margin (or required free capital) in proportion of reinsurance receivables.

a. Technical provisions and the credit of reinsurance

The typical regulatory approach to regulate technical provisions and the credit of reinsurance is adopted by the United States.

(1) U.S. NAIC Model Law

Before describing the regulatory approach in the United States, it is essential to introduce the framework of solvency regulation as a background for further discussion. Although the insurance industry is regulated by the individual states, the National Association of Insurance Commissioners formed by regulators in 55 territorial jurisdictions has issued a series of model laws, regulations and guidelines concerning regulation of insurance.

In terms of solvency requirements, the essential component of the solvency regulatory system is Risk-based Capital Approach specifying a minimum amount of capital based on the company's risk profile. As a result of drawbacks caused by the fixed-ration approach[72], risk based capital models have been developed to assess risk elements that an insurer may encounter and to determine the solvency of an insurer. In general, risks are divided into the following categories: "a. Asset risk, b. Interest risk for life insurance and health credit risk for accident and health insurance, c. Underwriting risk, d. Credit risk (unrecoverable reinsurance of property and casualty insurance), d. Other business risk.[73]" To ensure the financial solvency of an insurer, an insurer is required to prepare and submit to the commissioner an annual report of

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[72] It has been summarised that the fixed-ratio basis may have the following shortcomings.
(i) Inadequate respond to different risk profiles of individual insurers such as underwriting risk, and investment risk.
(ii) "to the extent exposure is based on historical data, there is no explicit dynamic, forward looking basis for the approach."
(iii) "a general model may be vulnerable to the choice of exposure basis and respond illogically, e.g., by increasing requirements in respond to stronger premiums or safer technical provisions, and decreasing requirements with rebates on premiums or with weaker reserving".
IAIS Sub-Committee, *supra* note 29, at 19..

[73] IAIS Sub-Committee, . *supra* note 29, at 29. For details, NAIC, *Risk-based Capital (RBC) for Insurers Model Act*, Model Laws, Regulations and Guidelines-Company Organization, Management, Securities Vol. II, § 2 C, at 312-3-4. (July 2001).

its RBC Levels[74]. When the insurer's Total Adjusted Capital[75] is below the level determined by this Model Law, it may trigger a governmental intervention[76] to control the operation of the insurer.

As a result of the large increase in insurance insolvencies in the 1980s[77], a draft of the model addressing reinsurance regulation was published in 1983[78]. After efforts have been taken by many regulators to propose an appropriate model and resolve the relevant issues, the Credit for Reinsurance Model Law was adopted by NAIC in 1996.

The amount of credit given to the reinsurance cover is regulated by various requirements. A primary insurer is not allowed to use the credit for reinsurance to reduce its technical provisions unless the reinsurer who transacts with this primary insurer meets relevant requirements provided by the insurance regulation. From the viewpoint of a primary insurer, the credit for reinsurance can reduce its required technical provisions and extend its capital capacity to underwrite business. If the technical provisions are not allowed to be reduced, a primary insurer's RBC level ratio may be below before the credit for reinsurance given to the insurer's financial statements. Consequently, it might trigger a governmental intervention or prevent the primary insurer from expanding business without adequacy of technical provisions.

To meet the requirements provided by the NAIC Credit for Reinsurance Model Law, the regulation generally addresses the importance of the domiciled and licensed jurisdiction. The main purpose of this approach is to prevent domestic primary insurers from ceding business to a reinsurer who locates in another jurisdiction and beyond the state regulator's supervision[79]. In this regard, credit for

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[74] RBC Levels are divided into four control levels. (i) Company Action Level RBC. (ii) Regulatory Action Level. (iii)Authorised Control Level RBC, (iv) Mandatory Control Level RBC. NAIC, *Risk-based Capital (RBC) for Insurers Model Act*, Model Laws, Regulations and Guidelines-Company Organization, Management, Securities Vol. II, § 1 J, at 312-2.

[75] Total adjusted capital means the sum of an insurer's statutory capital and surplus as determined in accordance with the statutory accounting principles. It may be adjusted by the RBC Instructions. *Id.* at § 1 L, 312-2.

[76] In the event of a regulatory action level event or lower action level (authorized control action and mandatory control), the commissioner shall take action as are necessary to cause the insurer to be placed under regulatory control *e.g.*, a corrective order. *Id.* at § 4, 5 and 6, 312-6, 312-9.

[77] Lee R. Russ & Thomas F. Segalla, COUCH ON INSURANCE § 9:5, at 1 (3rd edition, 1995).

[78] NAIC, *Reinsurance: Credit for Reinsurance Model Law- Legislative History*, in NAIC MODEL LAWS, REGULATIONS AND GUIDELINES VOL.V, 785-13 (1999).

[79] It has been observed, "a principal regulatory tool applicable to reinsurance, particularly reinsurance ceded to unauthorized insurers, is the recognition on a ceding company's financial statement of credit for unearned premium and loss reserves ceded to an assuming insurer." *Id.* at 785-14.

reinsurance is allowed when the reinsurance is ceded to an assuming insurer that is licensed to transact insurance or reinsurance[80]. In addition, when the security of reinsurance is at the centre of the regulatory purposes, credit for reinsurance is allowed if a primary insurer transacts with "an accredited reinsurer[81]" who is already subject to "substantial equivalent" solvency regulation[82]. In order to eliminate the vague "standards of solvency" stated in the previous model law[83], Credit for Reinsurance Model Law provided the precise requirements addressing the required amount of policyholder's surplus and accreditation procedure[84].

In addition to the reinsurer who is licensed or accredited in the same state, this Model Law provided the alternative requirements to allow the credit given to the ceding insurers. Due to lack of a single license regulatory system among the states, reinsurers licensed in one state should apply for authorisation to carry on reinsurance business in another state. To facilitate reinsurance transactions and avoid the multiple regulatory standards, Credit for Reinsurance Model Law allowed the credit for reinsurance when the reinsurers were licensed and supervised in the state employing standards "substantially similar[85]" to those in the model[86]. Second, credit is given to

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[80] NAIC, *Reinsurance: Credit for Reinsurance Model Law*, § 2A, *supra* note 4, at 785-1.
[81] To qualify as an accredited reinsurer, the following requirements should be satisfied.
"(a) Files with the commissioner evidences of its submission to this state's jurisdiction;
(b) Submit to this state's authority to examine its books and records;
(c) Is licensed to transact insurance or reinsurance in at least one state, or in the case of a U.S. branch of an alien assuming insurer, is entered through and licensed to transact insurance or reinsurance in at least one state;
(d) Files annually with the commissioner a copy of its annual statement filed with the insurance department of its state of domicile and a copy of its most recent audited financial statement;
(i) Maintain a surplus as regards policyholders in an amount not less than \$ 20,000,000 and whose accreditation has not been denied by the commissioner within ninety days of its submission; or
(ii)Maintain a surplus as regards policyholders in an amount less than \$ 20,000,000 and whose accreditation has been approved by the commissioner." NAIC, *Reinsurance: Credit for Reinsurance Model Law*, § 2B, *id*, at 785-1, 785-2.
[82] NAIC, *supra* note 78, at 785-14.
[83] *Id.* at 785-15.
[84] NAIC, *Reinsurance: Credit for Reinsurance Model Law*, § 2 B (d)(i)(ii), *supra* note 4, at 785-2.
[85] To determine the substantial similar standards, the drafting note for this section stated that "the term substantial similar means standards that equal or exceed that the standards of the enacting state, as determined by the commissioner of the enacting state. It is expected that the NAIC will maintain a list of states whose laws establish standards that equal or exceed the standards of this model act." It is suggested the NAIC accreditation approach to harmonise the supervisory standards among the states has been suggested to apply in the programme for reinsurance. It should be noted that the commissioner is responsible to determine the standards. In addition, it is argued that "tying the standard to the NAIC accredited status of the reinsurer's state of domicile could result in denial of credit even where the lack of NAIC accredited status was unrelated to that state's credit for reinsurance standards". As a result, such an accreditation procedure determined by the NAIC has not been drafted into this section. NAIC, *supra* note 78, at 785-15.
[86] NAIC, *Reinsurance: Credit for Reinsurance Model Law* § 2C, *supra* note 4, at 785-2.

reduce technical provisions when a primary insurer can ensure the security of reinsurance by ways of trust fund established "in a qualified US financial institution for the payment of the valid claims of its US ceding insurers, their assigns and successors in interest[87]". This Model Law specified the relevant requirements relating to a recognised trust fund. The requirements consist of two main components concerning the commissioner's approval[88] and qualified assuming insurers or groups[89]. Furthermore, credit permitted by this arrangement will not be allowed unless the reinsurer agrees certain arrangements concerning the role and power of the commissioner in the event of inadequacy of the trust fund[90]. In addition to the respective requirements for the two kinds of reinsurers stated above, credit shall be allowed when the reinsurance is ceded to a reinsurer only "as to the insurance of risks located in jurisdictions where reinsurance is required by applicable law or regulation of that jurisdiction.[91]" In the event of an unlicensed or unaccredited reinsurer, the credit for reinsurance permitted by the Section C and D will not be allowed unless the

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[87] *Id.* Reinsurance: Credit for Reinsurance Model Law § 2 D, at 785-2, 785-3.

[88] With respect to approval from the commissioner, the form of the trust and any amendments to the trust have approved by "(i) The commissioner of the state where the trust is domiciled" or "has been approved by the commissioner of another state who has accepted principal regulatory oversight of the trust." In addition, the form of the trust and amendment should be filed with the commissioner of every state in which the ceding insurer beneficiaries of the trust are domiciled. The trust shall remain in effect for as long as the reinsurer's outstanding obligation due. *Id.* Reinsurance: Credit for Reinsurance Model Law § 2 D (2), at 785-3.

[89] In the NAIC Model Law, the requirements apply to the different categories of reinsurer. For the single reinsurer, a trusteed surplus of not less than $ 20,000,000 is required as well as the funds in trust in an amount not less than the reinsurer' liabilities attributable to reinsurance ceded by U.S. ceding insurers. For a group including incorporated and individual unincorporated underwriters, the group is required to establish a trust "in an amount not less than the group's several liabilities attributable to business ceded by U.S. domiciled ceding insurers to any member of the group" and to maintain the certain amount of surplus. In addition to the requirements relating to a trust fund and surplus, a group should be subject to a similar regulatory control and should submit its financial statements within 90 days. *See id.* Reinsurance: Credit for Reinsurance Model Law § 2 D (3), at 785-3.

[90] In this section, this Model Law required the agreements addressing the supervision of the commissioner. In the event of inadequacy of the trust fund (e.g., the grantor of the trust has been declared insolvent), the trustee shall comply with an order of the commissioner. The assets should be distributed by and claims should be filed with and valued by the commissioner with regulatory oversight. If the commissioner determined that the assets of the trust fund are not necessary to satisfy the claims of the U.S. ceding insurers of the grantor of the trust, the assets should be returned to the trustee. "The grantor shall waive any rights otherwise available to it under US law that is inconsistent with this provision." *See id.* Reinsurance: Credit for Reinsurance Model Law § 2 G, at 785-5, 785-6.

[91] The main purpose of this section is to allow the insurance risks located in the jurisdictions other than in the United States to be assumed by the state-owned reinsurers or reinsurers when the applicable insurance law and regulation in that jurisdiction required the compulsory cession. *See id.* Reinsurance: Credit for Reinsurance Model Law § 2 E, at 785-5.

reinsurer agrees certain conditions in the reinsurance agreements with respect to jurisdiction and arbitration[92].

In the case of ceding business to an unauthorised reinsurers not meeting the requirements of Section 2, the credit for reinsurance to reduce technical provisions can not be allowed unless certain amount of security has been held by or on behalf of the primary insurer[93].

(2) The Mexican regulatory approach

As the regulators in the United States have developed a comprehensive regulatory regime concerning the creditworthiness of reinsurance, similar regulatory approaches have been also adopted or modified in some countries. Although the concept of regulatory approach addressing the control on technical provisions adopted by these countries is similar to that in the United States, the content of regulation might be different from that in the United States which gives emphasis to the domestic reinsurers and accredited reinsurers. For instance, the regulatory approach in Mexico seems more flexibly than that in the United States. Due to market characteristics and lack of domestic capital capacity, foreign reinsurance is crucial to promote domestic insurance market and to stabilise the growth of insurance business. As a result, the emphasis on the quality of reinsurance is given to the security of reinsurance rather than the domicile-oriented basis in United States. In the past, the regulation in Mexico was similar to other emerging markets where the reinsurance regulation generally focused on the risk retention and compulsory cessions to state-owned reinsurers. To correct the deficiency to supervise the quality of reinsurance, a new regulatory regime

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[92] With respect to jurisdiction, a reinsurer shall agree in the agreements "to submit to the jurisdiction of any court of competent jurisdiction in any state of the United States, will comply with all requirements necessary to give the court jurisdiction in any state of the United States, will comply with all requirements necessary to give the court jurisdiction, and will abide by the final decision of the court or of any appellate court in the event of an appeal." In addition, a reinsurer agrees to "designate the commissioner or a designated attorney may be served any lawful process in any action, suit or proceeding instituted by or on behalf of the ceding company". If this obligation is created in the agreement, the obligation of both parties to a reinsurance agreement to arbitrate their disputes will not be affected by the above section concerning the litigation. *See id.* Reinsurance: Credit for Reinsurance Model Law § 2 F, at 785-5.

[93] The Model Law approved several forms of security. (i) Cash, (ii) Securities listed by the Securities Valuation Office of the National Association of Insurance Commissioners and qualifying as admitted assets; (iii) "Clean, irrevocable, unconditional letters of credit, issued or confirmed by a qualified U. S. financial institution" and such a letter of credit should, "notwithstanding the issuing (or confirming) institution's subsequent failure to meet applicable standards of issuer acceptability, continue to be acceptable as security until their expiration, extension, renewal, modification or amendment, whichever first occurs" (iv) "any other form of security acceptable to the commissioner." *id.* Reinsurance: Credit for Reinsurance Model Law § 3, at 785-6, 785-7.

concerning reinsurance was enacted by the National Insurance and Surety Commission (CNSF) in 1996[94]. This new regulatory regime can be summarised in the following points: "(i) to establish a specialised reinsurance surveillance scheme within the CNSF, (ii) to support specialised inspection activities, (iii) to establish a legal framework to regulate the maximum retention limits, (iv) to establish a technical reserve for domestic companies considering the reinsurers' quality, and (v) to impact the solvency margin of ceding companies in the case of use of a low quality reinsurer, for foreign reinsurers, to modify the registration basis in order to have an updated situation of their claim pay ability (General Foreign Reinsurers Register); and for reinsurance brokers, (a) to implement the use of domiciled reinsurance brokers, and (b) to strengthen the legal sanctions regime for intermediaries' malpractice.[95]" As one of the main components of the regulation is to ensure the adequacy of technical reserve in relation to reinsurance, the quality of reinsurance should meet the requirements of insurance supervisors to reduce the technical provisions of a primary insurer. In terms of quality of reinsurance, a registration system with use of rating certificates is implemented for those foreign reinsurers who intend to carry on reinsurance business in Mexico. To obtain this register, reinsurers should have a satisfactory evaluation of an international specialised rating agency (e.g., Standard & Poor's, A.M. Best, Moody's, and Duff and Phelps)[96]. In the event of non-registered reinsurers, a Special Reinsurers Quality Technical Reserve[97] is required to be created in order to reduce the credit risk arising from reinsurers. In addition to the required special reserves, such additional technical provisions may consequently affect the solvency margin of primary insurers and the required primary insurers to increase

[94] *See* Manuel Aguilera-Verduzco, *supra* note 13, at 3.
[95] *See id.* at 3.
[96] To qualify to obtain the register, the minimum ratings are Standard & Poor's: BBB- or higher; A.M. Best: B+ or higher; Moody's: Baa3 or higher; Duff and Phelps: BBB-or higher. *See id.* at 4.
[97] In this approach, this special technical reserve is considered as part of the technical reserve investment basis in a regulated investment regime. The calculation methods for this approach are described as follows.

$$Rtcr = \sum_{i=1}^{n} \left[(Pc - Prrc) + Cnp \right]$$

$Rtcr$ = Special Reinsurance Quality Technical Reserve
Pc = Premium Ceded to a Non-registered Reinsurer.
$Prrc$ =Retained Premium Ceded to a Non-registered Reinsurer.
Cnp =Non-proportional Reinsurance Cost Paid to a Non-registered Reinsurer.
n =Total Number of Non-registered Reinsurers which the Insurance Company Worked With.
See Manuel Aguilera-Verduzco, *supra* note 13, at 5.

their required capital to protect their reinsurance programme in the short term[98]. After the implementation of this new regulatory regime addressing the quality of reinsurance, it has been observed that "the quality of the foreign companies now registered offers a level of security in reinsurance operations that did not exist before, and this helps to reduce the solvency problems that domestic companies might face due to ceded risks[99]".

b. Solvency margin approach

In contrast to the regulatory approach on the technical provisions, ensuring the quality of reinsurance can be achieved by way of laying down the relevant requirements on the required solvency margin. In the European Union, the regulatory approach concerning the solvency of reinsurers is the minimum capital requirement, called required solvency margin[100].

With regard to reinsurance and its effect on solvency requirements, the credit for reinsurance may be allowed to calculate the required solvency margin in some member states. In these member states, the reduction is restricted and should not exceed 50 percent for non-life insurance and 15 percent for life insurance[101]. Note, however, that regulation of reinsurers may still vary in these countries that impose limitation on the calculation of required solvency margin. For instance, the UK model imposed limitation on the amount of cession in the calculation of required solvency margin. Reinsurers who intend to conduct business in UK are required to obtain authorisation from the Financial Services Authority[102]. As a result, the quality of reinsurance has been considered by ways of the framework of direct regulation of reinsurers. In contrast to the direct regulatory approach in the UK model, the current German system of reinsurance regulation focuses on the ceding insurers rather than *direct regulation* of reinsurers. Foreign reinsurers are exempted from the direct supervision in Germany whereas German reinsurers are subject to strict accounting guidelines, submission of financial statements and regulation concerning adequacy of technical provisions, on the spot inspection and fines for non-compliance with

[98] *See id.* at 5.
[99] *See id.* at 4.
[100] IAIS Sub-Committee, , *supra* note 29, at 25.
[101] It should be noted, however, that other member states do not give any credit for reinsurance and insisted on the gross reserving basis. *Id.* at 26.
[102] *See* T. HENRY ELLIS & JAMES A. WILTSHIRE, *supra* note 9, at B.3.3-02 (Issue 63, Feb./2000).

accounting and financial rules[103]. In addition, a direct insurer in Germany is required to assess the adequacy of reinsurance and the creditworthiness of reinsurers. In the event of inadequacy of reinsurance, it may trigger the governmental intervention of the insurance regulators (the Bundesaufsichtsamt fuer das Versicherungswesen)[104].

Besides the EU, a similar regulatory framework has been considered or modified in other countries, e.g., Australia. With regard to solvency requirements in Australia, the solvency margin is related to the level of premium income or the level of outstanding claims[105]. In relation to reinsurance and solvency requirements, the Australian solvency requirements are net reserve based, which means that the amount of reinsurance can be allowed to reduce the required solvency margin. In the absence of limitation on the amount of cession to reduce the required solvency margin, the credit for reinsurance is allowed only if the reinsurance policies of a primary insurer have been approved by the insurance regulators (the Australia Prudential Regulation Authority(APRA). With regard to foreign reinsurers, however, the Australian insurance regulators adopt a spread rule for foreign reinsurance to ensure the creditability of reinsurance by implementation of the guidelines issued by APRA[106]. A spread rule for foreign reinsurance is that in the event of unauthorised reinsurers, the ceding insurance risk should not be more than 10 percent of the risk in the case of a lead reinsurer and 5 per cent of the risk in the case of other participants. By doing so, it may reduce the concentration of ceding risk to unauthorised reinsurers and the financial impact resulting from the credit risk of such reinsurers[107]. On the other hand, as the domestic reinsurers are subject to a similar solvency margin requirement and capital requirement applied to insurers[108], the quality of reinsurance can be maintained and supervised by the APRA.

B. Reinsurance Contracts and Solvency of Primary Insurers

Although the main topic of this chapter is to discuss the security of reinsurance, a regulatory issue may arise concerning whether a reinsurer can pay an amount based

[103] § 1 Abs. 2 VAG: §§ 55-59 VAG. *See* Michael Pickel, *supra* note 17, at 5.
[104] § 5 Abs. 5 Nr. 2 VAG: § 81 Abs. 1 VAG: BAV Rundschreiben R1/97. *See id.* at 5.
[105] 20 per cent net premium income, or 15 per cent of the net outstanding claims provisions. *See* Richard Smith, *Reinsurance Issues for Supervisors*, OECD, at 3 (11 November 2001), at<www.oecd.org>.
[106] In addition to relevant insurance law, the regulatory approaches relating to the quality of reinsurance has been based on the guidelines developed in consultation with the industry. *See id* at 4.
[107] *See id* at 4.
[108] *See id.* at 3.

on the actual amount the insolvent insurer can pay in order to limit its liability in the event of insolvency of the primary insurer[109]. The significant case addressing this issue in the US is *Fidelity and Deposit Company v. Pink*[110]. In that case, the reinsurer-Fidelity and Deposit Company argued that the reinsurance contract as an indemnity contract reimburses the liquidator-Pink (the Superintendent of Insurance for New York) only with respect to that proportion of losses the liquidator actually paid to claimants. On the other hand, Pink contended that the reinsurer should pay the amount based on the reinsurance contract regardless of the actual amount the insolvent company was able to pay the claimants. Based on the reinsurance agreement, "which the Court found made payment of a claim a condition precedent to reinsurance recovery, the United States Supreme Court found for the reinsurer"[111]. As a result of this case, some states in the US require that reinsurance contracts contain an Insolvency Clause, which obligates the reinsurers to pay the reinsurance proceeds to the domiciliary liquidator based on the liability of the primary insurer, regardless of the primary insurer's insolvency[112].

In the event of insolvency of the primary insurer, the policyholders generally have no right to collect from the reinsurers and the reinsurance proceeds pay to the liquidator administrating the insolvent primary insurer's assets[113]. A significant exception[114], however, would occur when the reinsurance contract contains a cut-through endorsement that allows the policyholder to sue the reinsurers directly in certain circumstances. As a result of the advantage of cut-throught clause that entitles

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[109] ROBERT W. HAMMESFAHR & SCOTT W. WRIGHT, *supra* note 41, at 251-252.
[110] 302 U.S. 224 reh'g denied, 302 U.S. 780 (1937).
[111] ROBERT W. HAMMESFAHR & SCOTT W. WRIGHT, *supra* note 41, at 252 (1994).
[112] For instance, in 1939, New York passed Section 77 of the New York Insurance Law. New York Insurance Law §1308[a][2][A]. *See* R. MICHAEL CASS, PETER R. KENSICKI, GARY S. PATRICK, ROBERT C. REINARZ & DORIS HOOPES, REINSURANCE PRACTICES VOL.1, 25(Institute of America, 2nd ed., 1997). *See also* T. Darrington Semple, Jr. & Robert M. Hall, *The Reinsurer's Liability in the Event of Insolvency of Ceding Property and Casualty Insurer*, 21 Tort & Ins. L.J.407 (1980). (12 Dec. 2001), available at <http://www.robertmhall.com/articles/j.htm#N_1_>.
[113] For US cases, *e.g., Avondale Mills, Inc. v. American Re-Ins. Co.*, 89-2514HA, 1991 U.S. Dist. LEXIS 20, 632 (W.D. Tenn., Aug. 5, 1991); *Florida ex rel. O' Malley v. Department of Ins.*, 155 Ind. App. 168, 291 N.E. 2d 907 (1973); *People ex rel. Baylor v. Highway Ins. Co.*, 57 Ill.2d 590, 316 N.E. 2d 633 (1974). Cited by ROBERT W. HAMMESFAHR & SCOTT W. WRIGHT, *supra* note 41, at 255.
[114] New York status allows some exceptions for insolvency clause when "(a) the reinsurance agreement specifies another payee of such reinsurance in the event of insolvency of the ceding insurer, and (b) the assuming insurer with the consent of the direct insureds, has assumed such policy obligation to the payees as a replacement for the obligations of the ceding insurer." §1308 (2)(B(i) and (ii)) of the New York Insurance Code., cited by T. Darrington Semple, Jr. & Robert M. Hall, *supra* note 112.

the policyholder to proceed directly against the reinsurer for the payment in the event of insolvency of the primary insurer, there have been regulatory and legislative debate concerning the enforcement of cut-through endorsement in the United States[115]. It should also be noted that insolvency laws and contract laws, which vary from country to country, might affect the validity of this endorsement. In the United States, Courts have upheld cut-through endorsements in certain circumstances[116]. For instance, the cut-through endorsement must be clearly stated and must contain express language that the insured will be paid by the reinsurer directly or that the insured can sue the reinsurer directly in certain circumstances[117]. By contrast, it has been criticised that the cut-through clause is contrary to public policy and effectively illegal under English Law[118]. There are few cases examining the cut-through clause in English Law. In 1975, House of Lords[119] held that the fundamental principle of *pari passu* distribution of the insolvent company's assets and states mandates that any preferences not expressly permitted by the insolvency legislation would be contrary to public policy.

As a result of legal disputes arising from enforcement of cut-through clauses, the reinsurer should consider the potential risk for double exposure to the policyholder and liquidator. From the viewpoint of the policyholder, the cut-through clause, which is to entitle an insured to collect the payment directly from the reinsurer, provides additional protection for the insured in the event of insolvency of the primary insurer. Nevertheless, it is crucial to consider the interest of other claimants when the preferences have not been expressly permitted in the relevant insolvency legislation.

C. Corporate Governance and Internal Controls

It has been observed that "good corporate governance is critical in setting the incentives for a financial institution to act prudently and for control of the risks which

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[115] *See generally* Reinsurance Association of America, *Issues-Receivership: Cut-Through*, (12 Dec. 2001), at< http://www.raanet.org/policyupdate/cut-throughs/>.

[116] *See Klockner Stadler Hurter, Ltd. v. Insurance Co. of Pennsylvania*, 785 F. Supp. 1130 (S.D.N.Y. 1990).

[117] *See* California Insurance Code Section 922.2. cited by Christopher Braithwaite, *Cut-through Clauses*, JTW, (12 Dec. 2001), at <http://www.jtw-re.com/ruklegal1.htm>. *See also Chawki Kadoub v. Liberian American Insurance Corp* No. 12405/91 (N.Y. Sup. Ct. Nov. 16, 1991), 2 Mealey's Reins. Rep. No. 14, at A-1., cited by ROBERT W. HAMMESFAHR & SCOTT W. WRIGHT, *supra* note 41, at 257.

[118] Peter Sharp, *Cut-through Clauses*, London Engineering Group, (12 Dec. 2001), at<http://www.leg-uk.org/cutthru.htm>.

a financial institution takes.[120]" Good corporate governance requires not only to strengthen shareholders' influence and control on corporate management but also to enhance internal control mechanisms and policies to ensure the key personnel act in the interest of the enterprise[121].

In terms of a primary insurer, good corporate governance is essential to limit or manage the amount of risk that they assumed or operated such as insurance risk and investment risk. From the viewpoint of insurance regulators, the establishment of relevant requirements for corporate governance can be used as a mechanism to require primary insurers committed to achieving regulatory objectives[122] and meeting the regulatory requirements.

1. The importance of corporate governance and internal control to primary insurers' reinsurance arrangements

In the area of insurance industry, governance problems can be categorised into the two different kinds of insurance business. In "non-life insurance", governance problems arise because "the poor management decision such as a rapid expansion in market share or a deliberate reduction in underwriting standards often can produce a dramatic decline in profits.[123]" By contrast, governance problems in "life insurance" focuse on "the continuity of operation and the ethicality of management"[124]. Given the function of reinsurance as a mechanism for extending the capital capacity of primary insurers to underwrite insurance business, the collection problems of reinsurance

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[119] *British Eagle International Airlines Limited v. Compagnie Nationale* [1975] 1WLR 758. cited by Christopher Braithwaite, *supra* note 117. *See also* Peter Sharp, *id.*

[120] JOSEPH J. NORTON, *supra* note 14, at 52.

[121] Norbert Seiler, *Implementation of International Standards: The EBRD's Approach to Strengthening Good Corporate Governance*, in THE REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE 327-328 (Rosa M. Lastra ed., Kluwer, 2001).

[122] It has been provided by IAIS that insurance regulators have responsibility to establish relevant requirements for corporate governance. "Insurance Core Principles 4: It is desirable that standards be established in the jurisdictions which deal with corporate governance. Where the insurance supervisor has responsibility for setting requirements for corporate governance, the insurance supervisor should set requirements with respect to: a. the roles and responsibilities of the board of directors; b. reliance on other supervisors for companies licensed in another jurisdiction; and c. the distinction between the standards to be met by companies incorporated in his jurisdiction and branch operations of companies incorporated in another jurisdiction." *See* INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, INSURANCE CORE PRINCIPLES, *supra* note 68, at 8.

[123] Stephen R. Diacon & Noel O'Sullivan, *Does Corporate Governance Influence Performance? Some Evidence From UK Insurance Companies*, 15 INTERNATIONAL REVIEW OF LAW AND ECONOMICS405, 407 (Elsevier Science, December 1995).

[124] This is because life insurance operation "are long term and fiduciary in nature and attempt to build contractual relationship between the company and its customers that may last for several years". *Id.*at 407.

arrangements, which include the credit risk of reinsurers, legal disputes arising from reinsurance contracts and inadequacy of reinsurance coverage, can be reduced by introducing proper corporate governance to promote risk management.

In relation to reinsurance arrangements, an institutional framework for sound corporate governance should establish an evaluation procedure to assess creditworthiness of reinsurers and to develop effective means to measure and monitor the reinsurance contracts as well as the adequacy of reinsurance coverage. In addition, collection of reinsurance should be considered in the framework of internal control. Such a procedure should provide the process of reinsurance claim, identify the collection problems (e.g., legal disputes, financial condition of the reinsurers, jurisdiction), and the approaches to achieve collection (e.g., negotiation, collateral, arbitration and litigation)[125].

To develop an evaluation procedure for reinsurance arrangements, the private rating agencies can be considered as an essential tool to assess the creditworthiness of reinsurers. Due to lack of inadequacy of information concerning reinsurers, a primary insurer may fail to assess the financial condition of reinsurers accurately and consequently credit risk of reinsurance may arise. As a result of the advantages of the assessment of reinsurers provided by these private rating agencies, a primary insurer should develop the relevant procedure to use these rating agencies.

2. International supervisory standards and the IAIS Core Principles for corporate governance and internal control

In order to ensure improved supervision of the insurance industry on the domestic as well as on an international level and maintain efficient, fair safe and stable insurance market, the International Association of Insurance Supervisors has issued the Insurance Code Principles which comprises essential principles and are intended to serve as a basic reference for insurance supervisors in all jurisdictions in October 2000[126].

In relation to corporate governance, it addresses the responsibility of insurance supervisors to establish requirements for corporate governance concerning the

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[125] For these elements of the reinsurance collection process *See* Thomas Warnke, *supra* note 11 at 37-56.

[126] INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, INSURANCE CORE PRINCIPLES, *supra* note 68, at 4.

following matters:

"a. The role and responsibilities of the boards of directors

b. The reliance on other supervisors for companies licensed in another jurisdiction

c. The distinction between the standards to be met by companies incorporated in his jurisdiction and branch operation of companies incorporated in another jurisdiction.[127]"

To facilitate the assessment of the implementation of these principles, the Insurance Code Principles Methodology has been proposed to provide detailed criteria for insurance supervisors to carry on self-assessments or review[128]. The criteria relating to corporate governance addresses the insurance supervisor's responsibilities toward verifying and enforcing observance of those requirements[129].

With respect to reinsurance arrangements, the insurance supervisor should "have authority to require boards or directors to have in place and to monitor independent risk management functions related to the type of business undertaken[130]". In other words, boards or directors are required to monitor the risk management functions including the risk transfer instruments such as reinsurance.

With regard to internal control, the Insurance Code Principles recommended

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[127] Principle 4: Corporate Governance of Insurance Code Principles, INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, INSURANCE CORE PRINCIPLES, *supra* note 68, at 8.

[128] INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, CORE PRINCIPLES METHODOLOGY 4 (October 2000), (08 November 2001 visited), at<www.iaisweb.org>.

[129] The elements of the criteria can be summarised in the following aspects:
The responsibilities of boards of directors, their strategic objectives, the means for attaining those objectives and the procedure for evaluating their progress toward those objectives.
The nomination and appointment procedures, structure, functions, re-elections and balance between executive and non-executive directors of the board in a transparent manner.
Clarification of responsibilities which will ensure a balance of power and authority.
Control on risk management functions.
Protection of customers regarding customer complaints procedures, the enhancement of customer awareness and knowledge, and the assessment of business conduct at regular intervals.
The policies regarding conflicts of interest, fair treatment of customers and information sharing with stakeholders.
The policies regarding insider dealing.
Proper and full disclosure concerning corporate governance principles and attainment of stated corporate objectives.
A proper remuneration policy for directors and senior management, to review that policy and to disclose it to the insurance supervisors or to the general public.
INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, *id.* at 18-20.

[130] *Id.* at 19.

that the insurance supervisors should be able to review the internal control and require the board of the directors to provide suitable prudential oversight[131]. In terms of reinsurance arrangements of primary insurers, the insurance supervisor should require the boards of directors to provide suitable oversight of reinsurance arrangements[132]. In other words, the relevant assessment should be provided to enable the board of directors to monitor the efficiency of reinsurance arrangements and to identify the problems arising from reinsurance collection.

D. Summary Observations

An efficient reinsurance market provides the primary insurers with the capital capacity to underwrite and expand the business, the expertise to enhance the relevant experience, and the financial stability to smooth the fluctuations in underwriting results and to protect them against the potential large exposure from catastrophic events. However, the regulation concerning the security of reinsurance varies substantially in countries throughout the world.

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[131] According to Principle 5 of IAIS Insurance Supervisory Core Principles, the insurance supervisor should be able to

"review the internal controls that the board of directors and management approve and apply, and request strengthening of the controls where necessary; and

require the board of directors to provide suitable prudential oversight, such as setting standards for underwriting risks and setting qualitative and quantitative standards for investment and liquidity management."

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, INSURANCE CORE PRINCIPLES, *supra* note 68, at 8.

[132] The elements of essential and additional criteria provided by IAIS can be described as follows.

The review of internal control that board of directors and management approve and apply; when necessary the supervisory requests a strengthening of the controls.

Suitable prudential oversight, such as setting standards and monitoring controls for underwriting risks, valuation of technical provisions (policy liabilities), investment and liquidity management and reinsurance.

Suitable oversight of market conduct activities e.g., setting standards and monitoring controls on fair treatment of customers; proper disclosure to customers of policy benefits, risk and responsibilities; conflicts of interest.

Internal control to address issues of an organisational structure, accounting procedure, checks and balances.

Control on safeguarding of assets and investments, including physical control.

An ongoing audit function of a nature and scope appropriate to the nature and scale of the business.

Formal procedures to recognise potential suspicious transactions.

The establishment of lines of communication both to management, law enforcement authorities and/ or the insurance supervisor for the reporting of irregular and suspicious activities.

In relation to additional criteria, the insurance supervisor encourages the company to appoint experienced non-executive directors to the board in case of a unicameral board structure and the establishment of an internal audit function that reports to an Audit Committee of the board.

The insurance supervisors requires actuarial reporting where called for by applicable law or by the nature of the insurer's operations and where appropriate encourages the appointment of an actuary reporting directly to the board or directors.

To evaluate the security of reinsurance, a primary insurer should not only assess the financial solvency of the reinsurers but also draft the reinsurance contracts carefully. The quality and integrity of management is essential to ensure the quality of reinsurance and the good performance of business. As a result of financial impact from the legal disputes between reinsurers and the ceding insurers, the reinsurance wordings should be properly drafted. In addition to legal disputes, the ceding insurers should collect their reinsurance payment efficiently and any irrecoverable reinsurance should not be considered as assets in the solvency regulation accounting. With regard to financial solvency of the reinsurers, primary insurers and insurance regulators could evaluate reinsurers' adequacy of technical provisions, the investment of assets, and solvency margin. While the direct regulatory approach addressing the regulation of foreign reinsurers is not common in most countries, determining the security of reinsurance provided by reinsurers domiciled or licensed abroad should rely on the information gathered from other countries and the cooperation with foreign insurance regulators.

Regulatory approaches concerning creditworthiness of reinsurance can be designed either in the statutory accounting or in the required solvency margin. In comparison with these two approaches, the differences generally depend on the frameworks of solvency regulation. Furthermore, it appears that the level of regulation concerning the security of reinsurance differs from country to country. However, the foreign reinsurers have been supervised either by direct licensing requirements or the indirect regulation concerning the financial condition of reinsurers. Due to problems caused by the unauthorised reinsurers, these regulatory approaches addressed the security of reinsurance provided by these reinsurers.

In the United States, reinsurance can be used to reduce the ceding insurer's technical provisions if it meets the requirements, which are established by NAIC and then adopted by the states. In comparison with other regulatory approaches, it can be found that the approach in the United States emphasising the security of reinsurers licensed and domiciled abroad might lead to restricting the freedom of international reinsurance transactions although foreign reinsurers carrying on business are not subject to direct regulation and licensing requirements. In the event of ceding business

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INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, INSURANCE CORE PRINCIPLES, *supra* note 68, at 21-22.

to unauthorised reinsurers, reinsurers may either establish a multiple benficiary trust plus a required surplus amount or provide individual collateral to the ceding insurers[133]. As a result, it may increase the transaction costs caused by the requried trusts or collateral arrangements. However, it has been argued that "eliminating regulation that presents obstacles to the marketplace while introducing and/or maintaining sufficient financial security of the industry is a critical balance that must be reached."[134] Due to the large number of U.S. insurers insolvencies in the 1980s, the collateralisation of unauthorised reinsurers is established to ensure the recoverability of reinsurance. From the viewpoint of insurance regulators, such a collateral arrangement eliminates the needs to evaluate financial solvency of unauthorised reinsurers[135]. On the other hand, in Mexico, the evaluation of the security of reinsurance depends on the financial assessments provided by specific rating agencies. Unlike the reinsurance market in the US, the shortage of reinsurance is the main concern in many emerging markets. It is more difficult for insurance regulators in emerging markets to reach a balance between the security of reinsurance and the availability of reinsurance. As a result, the regulatory emphasis has been given to the financial solvency of reinsurers rather than the location of reinsurers. In the event of non-registered reinsurers, the special technical reserve concerning the recoverability of reinsurance will be imposed on the ceding insurers.

With regard to the regulatory approaches structured in the solvency margin of the ceding insurers, the approaches adopted by some EU countries restrict the reduction of required solvency margin. In doing so, it may reduce the ceding insurers' reliance on the reinsurance and limit the financial impact caused by irrecoverable reinsurance. The content of regulation varies among the EU member states. In the UK, reinsurers should be authorised to carry on reinsurance business even reinsurers domiciled in other member states are required to demonstrate their financial solvency. In this approach, the financial condition of reinsurers has been monitored and evaluated by the insurance supervisors and no reinsurer can be exempt from the scope of solvency regulation. By contrast, the regulatory regime in Germany imposed strict regulation on the ceding insurer's arrangements and the domestic reinsurers whereas foreign reinsurers are exempt from Germany's insurance regulation. Although it

[133] Debra J. Hall, *supra* note 27, at 7.
[134] *Id.* at 7.
[135] *Id.* at 6.

seems that the regulatory approach in Germany is less restrictive than other countries, it should be noted that the governmental intervention might be triggered in the event of inadequacy of reinsurance. In the Australian regulatory approach concerning the security of reinsurance, authorized reinsurers are subject to a similar solvency requirement as primary insurers whereas in the event of ceding business to an unauthorized reinsurer a spread rule will be imposed on the ceding insurers to prevent the concentration of credit risk of reinsurance.

Designing an appropriate regulatory regime generally depends on market characteristics and relevant regulatory arrangements. Among these approaches stated above, the collateralisation of reinsurance and trust fund requirements in the United States may not be appropriate for emerging markets with the problem of shortage of reinsurance. From the viewpoint of the arguments for the U.S. approach, the trust fund and collateral arrangements eliminate the uncertainty of the financial solvency of unauthorized reinsurers. As a result of the varying accounting principles, it is also problematic to assess the financial condition of the foreign reinsurers and may cause enormous costs to establish general acceptable accounting standards[136]. Furthermore, in the event of insolvency of unauthorized reinsurers, legal disputes arising under insolvency law may increase the obstacles for the ceding insurers when the reinsurer in receivership is subject to foreign insolvency laws. Introducing the collateral requirement and trust fund will not only eliminate the difficulties arising from insolvent reinsurers but also ensure the reinsurance collection. From the viewpoint of competition between authorized reinsurers and unauthorized reinsurers, it may provide the competitive advantages for unauthorized reinsurers without collateral arrangements while the authorized reinsurers encounter the regulatory costs.

It should be noted, however, that the significant costs associated with the collateral arrangements and trust funds may not be bearable for the ceding insurers in emerging markets with limited capital capacity. In addition, the main purpose of reinsurance, which is to absorb and diversify risk, should be addressed. It is not feasible to implement such a regulation while the shortage of reinsurance is the main concern in these markets. As a result, the regulation concerning the security of reinsurance should depend on the evaluation of foreign reinsurers rather than impose the restrictive regulation on the ceding insurers in the event of ceding business to a foreign reinsurer. Although the Mexican regulatory approach, which highly depends on the analysis by rating agencies, seems less developed than the approach in the United States, it has improved the security of reinsurance without increasing the cost of reinsurance and impeding the diversification of reinsurance risk.

In addition to governmental supervision, good corporate governance and sound internal control addressing the security of reinsurance should be incorporated into the framework of ensuring the solvency of primary insurers. Insurance undertakings should establish the criteria to review the reinsurance collection and the adequacy of reinsurance arrangements.

III. International Supervisory Standards and Guidelines

As a result of the trend towards harmonization of reinsurance regulation, the relevant supervisory guidelines and papers concerning the regulation of reinsurance issued and developed by the International Association for Insurance Supervisors (IAIS) are worth introducing.

A. IAIS-the Working Group's Issues Paper on Reinsurance.

International Association for Insurance Supervisors (IAIS), which has published Insurance Principles, Standards and Guidance Papers to serve as a guideline for the regulation and supervision of insurance market[137], is in the process of developing guidelines or standards in the areas of licensing, use of derivatives, on-site inspections, solvency, reinsurance, market conduct, and investment policies. With respect to reinsurance and reinsurers, the Working Group on Reinsurance (now the Reinsurance Subcommittee) established by IAIS issued a paper entitled: "Reinsurance and Reinsurers: Relevant Issues for Establishing General Supervisory Principles, Standards, and Practices" for developing guidelines in the area of reinsurance regulation and supervision in February 2000[138]. Although this paper does not reflect the view of the IAIS, this paper points out several essential issues and provides a good foundation for developing reinsurance regulations either in developed countries or in emerging markets[139]. In the area of regulation of reinsurance and reinsurers, the

[136] *Id.* at 13.
[137] *See* IAIS-Working Group on Reinsurance, IAIS-Working Group on Reinsurance, *supra* note 7, at 9.
[138] This paper cohered with the existing IAIS principles, standards, and guidance papers. *See generally id.* at 9.
[139] *Id.*at 1.

Working Group made the following recommendation to the Technical Committee, IAIS. First, a harmonized single licensing system should be established and be based on the mutual recognition of supervisory principles and practices among reinsurance supervisors[140]. Second, to facilitate mutual recognition among countries, the Working Group proposed that such a mutual recognition might be established on the regional basis[141]. Third, in order to obtain accurate information to assess the financial condition and the corporate structure of reinsurers, a database of all reinsurance companies throughout the world should be created and made accessible. In addition, the rating agencies could be invited to provide the relevant credit rating and the IAIS should be able to check the quality of the information they provided[142]. Fourth, a licensing or registration system for reinsurance companies should be implemented and such a system should be able to ensure the fit and proper quality of the key personnel[143]. As a result of increasing use of new risk transfer products (e.g., insurance-linked securities, and finite risk reinsurance) that may cause regulatory obstacles, the Working Group has placed their emphasis on the relevant issues and has recommended the improvement of regulators' expertise, accounting, and solvency requirements to keep pace with market dynamics[144]. In addition to substantial recommendations on the aspects stated above, this paper identified three issues[145] concerning the systemic risk[146] arising from current market consolidation, the industry's view on the database established by IAIS, and the requirements for licensing reinsurance companies.

In terms of the regulation of reinsurance, this paper identified several essential issues and proposed several approaches to regulate and supervise reinsurance activities more effectively. These issues and recommendations can be divided into the

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[140] *Id.*at 6.
[141] Regions could be the following groups. "A. North America, Australia and New Zealand gradually extended with the countries of Middle and South America; B. Japan and other Asian countries; C. the European Union, countries belonging to the European Economic Area and Switzerland, gradually extended to Middle and East European Countries; D. South Africa and other African countries." In addition, it provided the alternative approaches such as a similar market condition to recognise each other's supervisory approach. *Id.* at 6.
[142] *Id.* at 7
[143] *Id.* at 7.
[144] IAIS-Working Group on Reinsurance, *supra* note 7, at 7.
[145] *Id.* at 7.
[146] In relation to system risk and reinsurance, it has been observed that "it is unlikely that the reinsurance industry can be linked to systemic problems of financial stability". *See* Michael Hafeman, *supra* note 19, at 9. However, this observation only reflects the current situation in the reinsurance

following categories:

1. Sector Separation for Insurers and Reinsurers. While the separation of primary insurers between life insurance and non-life insurance is found in many jurisdictions, it is argued that a similar separation should also be applied to reinsurers. This paper categorised two kinds of reinsurers-primary insurers who also carry on reinsurance business and professional reinsurers who only conduct reinsurance business. For the primary insurers who also carry on reinsurance business, the sector separation should be applied because of the differences of risk characteristics and inadequacy of expertise[147]. However, the same separation regulations may not be appropriate to regulate professional reinsurers[148].

2. Supervision of reinsurance arrangements of a primary insurer

This paper summarised the following essential aspects concerning supervision of reinsurance arrangements of a primary insurer.

a. Information regarding reinsurers such as the country of registration, and financial condition.

b. The type of reinsurance treaties and the relevant information (e.g., the terms of the treaties, the cost of reinsurance, the coverage.)

c. The amount of the risk retention.

d. Plans for spreading risk to avoid the concentration of risk[149].

However, this paper only placed emphasis on the essential information regarding reinsurance arrangements of a primary insurer rather than providing a comprehensive approach to efficiently regulate a primary insurer to arrange their

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industry. As a result of the trends of consolidation of financial markets and increasing catastrophe risks, it is doubtful that reinsurance industry may not have significant impact on the global financial market.

[147] The main risks arising from life insurance business can be well identified and slow to change e.g. mortality risk. However, the risks of non-life insurance are not well predictable e.g. aviation and catastrophe. Therefore, the life insurers who also carry on non-life reinsurance may encounter difficulties from poor indemnity reinsurance result. *See* IAIS-Working Group on Reinsurance, *supra* note 7, at 42.

[148] This paper made the following observations to support that the absent of sector separation for professional reinsurers does not represent a significant impact on the insurance market. First, life reinsurance business, which is readily calculable risk and relative stable, may enhance the diversification of risks accepted by professional reinsurers. Second, the failure of reinsurers may not directly affect the policyholders. Third, the sector separation may impede the diversification of risk and restrict a sufficient volume of business from another sector. However, it should be noted that the failure of a reinsurers may consequently affect the financial stability of a primary insurers and hence the interests of the policyholders. *See* IAIS-Working Group on Reinsurance, *supra* note 7, at 42.

reinsurance arrangements.

3. Supervision of Reinsurers

In terms of supervision of reinsurers, the most controversial issue is to decide an appropriate regulatory model to regulate reinsurers. Should a reinsurer be supervised directly as a primary insurer who is subject to licensing requirements and solvency regulation? This paper analysed the advantages and disadvantages of supervising reinsurers directly and made the following observations.

As a result of market dynamics and the innovations of investment instruments, it becomes increasingly difficult for a supervisor and a primary insurer to ensure the recoverability of reinsurance. In directly supervising reinsurers, the supervisors will be able to assess the reinsurer's financial condition and enhance the reinsurer's financial stability by the relevant investment regulations. Due to the importance of the reinsurer's activity in the comprehensive chain of risk spread, it is necessary to supervise reinsurers directly to ensure the fitness and competence of key personnel of a reinsurance company[150].

Although both the objectives of the insurance regulation and reinsurance regulation are to ensure the financial security of insurers and reinsurers, the assessments may differ[151]. As a result of lack of definite and uniform procedures for the analysis of the annual account or for further check, ceding insurers and insurance supervisors may arrive at different results regarding a reinsurer's security; e.g. capital adequacy requirement or investment regulation[152]. Consequently, it may cause the multiple financial assessments of the reinsurer. To avoid the multiple assessments of the same reinsurer's security, a system of home control, including an adequate system of information exchange has been proposed by this report[153]. Such a system should be uniform and provide a level playing field for reinsurers. Furthermore, this paper suggests that a system of single license and home region control could be a possible solution not only to reduce the operational obstacles but also to maintain the financial stability of reinsurers. In addition to governmental supervision, this paper recognises the essentiality of private rating agencies and encourages the supervisors and the

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[149] *See id.* at 48.
[150] *See id.* at 49.
[151] *See id.* at 50.
[152] *See id.* at 50.
[153] *See id.* at 51.

ceding insurers to consider using these ratings in conjunction with other solvency regulation and the criteria to select the reinsurers.[154]

B. On Solvency, Solvency Assessments and Actuarial Issues-An IAIS Issues Paper (Final Version)

In addition to the general issues relating to reinsurance provided by IAIS, the IAIS Technical Committee, the parent committee of Solvency Sub-Committee, focused on the specific supervisory standards on solvency of primary insurers and issued the paper to discuss the general principles on capital adequacy and solvency as laid down by insurance supervisory principles[155].

Although this paper focused on the solvency requirements for primary insurers, it indeed raises several essential issues concerning reinsurance. First, it categorizes the financial impact arising from reinsurance arrangements, in terms of kinds of risk. One is that the reinsurance might prove insufficient to adequately cover the risk. The other is that a reinsurer might prove to be unable or unwilling to pay the claims. To prevent the risks stated above, it proposed that the directors of the insurers should assess properly the needs for reinsurance and the reinsurer's security or creditworthiness. Furthermore, it described some solvency practices in several countries.

C. Summary Observations: Weaknesses in the Reinsurance Subcommittee's Issues Paper

While the trends of liberalization of reinsurance and harmonization of insurance regulation have made a significant impact on emerging markets, the essential issues identified by the Reinsurance Subcommittee have provided a good foundation for further discussion and recommended a possible regulatory structure for those countries where the regulation of reinsurance needs to be enhanced.

As the recommendation made by the Reinsurance Subcommittee establish a possible model for future reinsurance regulation, it is obviously important for countries to consider the potential difficulties when implementing a new regulatory

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[154] The following commercial rating agencies provided in this paper have given their emphasis on reinsurers and insurers. A. M. Best Company; Standard & Poor's Corporation; and Duff & Phelps Credit Rating Corp. *See id.* at 51-52.

approach.

First, while mutual recognition is recommended by the Insurance Subcommittee, the regulatory arbitrage should be considered. It has been stated that "mutual recognition may result in the regulation at the level of the lowest denominator"[156]. For those countries with highly developed regulatory regime, a single license system may increase the competitive advantage for those reinsurers who are subject to less restrictive regulation. Second, the importance of reliable assessment standards is well recognized in mutual assessment. It has been argued that this paper failed to consider the obstacles of spelling out the standards[157]. To establish recognized and harmonized rules is difficult particularly in view of the varying solvency regulatory regimes in countries throughout the world. As a result, it has been suggested that "it is not until the International Accounting Standards Committee finalize its work for insurance and key financial centers have endorsed the standards and begun implementation of them that transparency in accounting and reporting standards can be achieved and discussions concerning mutual recognition made more meaningful.[158]" Third, this paper placed emphasis on the assessment of the security of reinsurance rather than providing possible regulatory approaches to ensure the security of reinsurance. Based on the arguments discussed above[159], a possible regulatory approach should take into account solvency regulation. The reduction of the amount of technical provisions or required solvency margin will not be allowed unless the creditworthiness of reinsurance has been ensured in reasonable costs. Fourth, while the needs of definite and uniform procedures have been addressed in this paper, the importance of an effective insolvency regime should be considered to reduce adverse effects in the event of the insolvency of a reinsurer. As a result of the increase in international reinsurance transactions, an effective insolvency regime[160]

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[155] IAIS Sub-Committee, , *supra* note 29, at 4.
[156] Debra J. Hall, *supra* note 27, at 11.
[157] *Id.*at 13.
[158] *Id.*at 14.
[159] *See* Section II, D Summary Observations of this chapter.
[160] With regard to international insolvency process, the following principles can provide the theoretical basis for discussion. Unity means that there are proceedings exclusively in the country of incorporation or at the place of business of the debtor. Plurality or multiplicity means that the possible exists to open more than one insolvency in order to liquidate or rescue a debtor's estate. Universality means that the proceedings relating to a company's insolvency will have worldwide extraterritorial effects. In contrast, territoriality means that the proceedings have a purely territorial, national scope. Nichi Kayser, *A Study of the European Convention on Insolvency Proceeds*, 7 INTERNATIONAL INSOLVENCY REVIEW 101 (1998).

may promote the ceding insurers' confidence to transact with foreign reinsurers and reduce unnecessary costs in collecting reinsurance proceeds. Last, while the Reinsurance Subcommittee recommended mutual recognition as basis for future harmonization of regulation, the cooperation between home country and host country is merely based on information exchange. It is suggested that mutual recognition should clarify the responsibility of the home country and the host country in a way that improves the access of home supervisors information and hence ensure that cross-border reinsurance operations are subject to effective supervision[161].

IV. Concluding Remarks: Implications for Reinsurance Regulation and Supervision in Emerging Markets

A coherent and comprehensive system of regulation of reinsurance with proper implementation is essential to maintain the stability of insurance market when reinsurance provides external capacity for the ceding insurers to expand their business. As the insurance regulators and ceding insurers struggle to ensure the critical balance between efficiency of reinsurance and security of reinsurance, the framework of regulation of reinsurance should be properly structured and take into

[161] In comparison with other financial regulations concerning cross-border operations, the Basle Committee and the Offshore Group of Banking Supervision has issued twenty-nine recommendations, as a supplement to the Minimum Standards, under the title of "The Supervision of Cross-Border Banking". In relation to cross-border operations, it should ensure that "all cross-border banking operations are subject to effective home and host supervision." For the host countries, it should "(1) Assist in providing the requisite information to home supervisors if this is not provided through other supervisory means; (2) Use its best endeavours to have its legislation, which prevents the access of home supervisors to depositor information, reviewed and, if necessary, amended; (3) Respond freely to any questions posed by a home supervisor on qualitative information and to inform the home supervisor if any area of concern comes to its notice; (4) Assist the home country to conduct on-site examination or undertake on-site examination on behalf of the home supervisor; (5) Ensure there is effective supervision of shell branches; (6) Ensure that operations of parallel-owned banks become subject to consolidated supervision; (7) Be extremely cautious about approving the establishment of cross-border operations by banks incorporated in under-regulated financial centers." For the home country, it should "(1) Expect parent banks to pass quantitative and qualitative information on to it freely and verify accuracy of this information and reassure itself that there are no supervisory gaps; (2) Conduct on-site examination; (3) Pass the information on series criminal violation of home country law immediately to the appropriate law enforcement authorities in its home country and inform the host supervisor of the action it intends to take; (4) Inform the host supervisor immediately if it has reason to suspect the integrity of the local operation, the quality of its management or the quality of internal controls being exercised by the parent bank; (5) Have on its regular mailing list for relevant material all foreign supervisors which act as hosts to its banks; (6) Inform host supervisors of material adverse changes in the global condition of banking groups operating in their jurisdictions; (7) Ultimate responsibility to assure that any gaps in supervising shell branches are closed; (8) Ensure that operations of parallel-owed banks become subject to consolidated supervision; (9) Monitor operations of a banking entity on a worldwide basis and ensure that no entity should be allowed to use the word "bank" in its name if it is not conducting banking activities and being supervised by a bank". BASLE

account market characteristics and the legal system. While the shortage of reinsurance is the main issue in emerging markets, insurance regulators should consider an appropriate regulatory approach that ensure the security/creditworthiness of reinsurance and reduce any adverse effects caused by regulation. In this regard, this section addressed key aspects of the reinsurance regulation and supervision in emerging markets.

First, all reinsurers should be subject to regulation as primary insurers. Although the direct regulation approach, which provides that all reinsurers should be authorized in order to carry on reinsurance, may not be appropriate for emerging market, foreign reinsurers should be regulated and supervised by the home country regulatory system. In other words, foreign reinsurers should be subject to the regulation of the country of domicile. Such a regulatory regime should be able to ensure the financial solvency of reinsurers and the fitness and propriety of management.

Second, in relation to the regulation concerning the creditworthiness of reinsurance, relevant solvency regulation should be able to assess the security of reinsurance and to reflect the recoverability of reinsurance. While the collateralisation of reinsurance or trust fund requirements can eliminate the regulators' burden and ensure the reinsurance collection, the costs associated with collateral arrangements may impede the diversification of insurance risk particular in emerging market with the shortage of reinsurance. Alternatively, regulators in emerging markets may choose less restrictive regulatory approaches (e.g., the Mexican model relying on the rating agencies or the spread rules in Australia) to reduce the financial impact on solvency of primary insurers. It should be addressed that there is no feasible regulatory approach to ensure the security of reinsurance unless the market characteristics, the legal system and other social factors has been properly considered.

Third, in addition to governmental supervision, good corporate governance and sound internal control should be introduced and implemented in the process of reinsurance arrangements for the primary insurers. Maintaining a stable financial market cannot merely rely on the regulators. As the failure of reinsurance may result from poor management, good corporate governance is essential to promote the risk

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COMMITTEE ON BANKING SUPERVISION AND OFFSHORE GROUP OF BANKING management of primary insurers to reduce financial risk. In relation to reinsurance arrangements of primary insurers, the relevant criteria concerning the adequacy of reinsurance and the recoverability of reinsurance should be structured into the framework of internal control.

As the efforts have been made to reach the harmonization of regulation of reinsurance by IAIS, it appears that several obstacles are needed to address further issues, such as regulatory arbitrage, varying assessment and an effective insolvency regulation. While the mutual recognition approach proposed by IAIS may encounter the oppositions from countries where there are highly developed regulatory regimes[162], the supervisory principles and relevant recommendations have contributed significant influence and an educational regulatory infrastructure for emerging markets in regulatory reform.

SUPERVISORS, THE SUPERVISION OF CROSS-BORDER BANKING (Oct. 1996).

[162] Debra J. Hall, *supra* note 27, at 10-13.

Chapter Three

Reinsurance Intermediaries and Regulation of Reinsurance

Reinsurance intermediaries, also known as reinsurance brokers[1], generally act as conduits in arranging reinsurance contracts, administration of these contract, and related claims negotiation and collection[2]. These intermediaries do not merely engage in arranging reinsurance for the ceding insurers but also accept or underwrite reinsurance business on behalf of the reinsurers[3]. The roles of reinsurance intermediaries vary considerably between countries throughout the world. For instance, German insurers tend to arrange reinsurance directly with reinsurers, whereas in Japan foreign intermediaries on the behalf of domestic insurers engage in placing reinsurance with reinsurers and also act as underwriting agents to acquire inward reinsurance[4]. In the developing countries, the intermediaries may be expected to provide their expertise in helping to understand relevant insurance law and regulation, and to assist domestic insurers in identifying their exposure. Moreover, they may be involved in arranging reciprocal exchanges of reinsurance business[5]. Although the reinsurance brokers are referred to as "intermediaries", it should be noted that the" reinsurance intermediaries has a larger function than merely affecting a contract between a reinsured and reinsurer"[6].

In terms of the reinsurance brokers, the duties of the reinsurance brokers can

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[1] It has been observed that "At the present time, particularly in reinsurance treaties, brokers are frequently referred to as intermediaries, a name perhaps slightly more elevated than broker." P. T. O'NEILL, & J. W. WOLONIECKI THE LAW OF REINSURANCE IN ENGLAND AND BERMUDA 333 (1998). It also has been argued in England that "the term of intermediary, although it is commonly used in reinsurance, has no legal definition, and in law a broker is an agent." BARLOW LYDE & GILBERT, REINSURANCE PRACTICE AND THE LAW 2-2 (LLP, Service Issue No. 15, 1 October 2000). It should be noted, however, that the term of reinsurance intermediary does not merely include the reinsurance broker who generally is deemed as the agent of insurers, but also include the underwriting agent who acts as the agent of the reinsurers and are known as managing general agents (MGAs) in the United States. As a result, this chapter will not only draw on the regulatory issues relating to reinsurance brokers but also will discuss issues relating to reinsurance underwriting agents.

[2] *See* John S. Diaconis, *Introductory Comments and Basic Overview of Reinsurance Term*, in REINSURANCE LAW & PRACTICE: NEW LEGAL AND BUSINESS DEVELOPMENTS IN A CHANGING GLOBAL ENVIRONMENT 1998, at 25 (Practising Law Institute-Commercial Law and Practice Course Handbook Series, PLI Order No. A4-4548, 778 PLI/COMM 7, October 1998).

[3] R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, REINSURANCE 55 (5th ed., 2000). In some cases, the brokers hold binding authority to assess and to assume risk on the behalf of reinsurers.

[4] *Id.* at 57.

[5] *Id.* at 56-57.

[6] *See* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 333.

be divided into three main parts: the duties to the reinsurers, the duties to the reinsured, and the duties to the third party. The reinsurance broker's basic duty arises from the contractual relationship between the broker and his principal-reinsured, and is in general the same as that of other brokers subject to the general law of agency. Legal issues regarding the duty of reinsurance brokers often arises in the following contexts:

(1) Issues regarding the authority of the reinsurance brokers such as sub-agent, dual agent, and ostensible authority; (2) Reasonable skill and care in the performance of placing reinsurance and selection of reinsurance security; (3) Collection of claims and preservation of documents; (4) the duties relating to defences-wavier, estoppel, ratification, contributory negligence and concurrent liability in tort; (5) and the duty as an adviser[7].

In addition to legal duties owed by the reinsurance broker to its principals, legal issues often arise from the bankrupcy of the parties involved in the reinsurance contracts and the complexity of the accounting custom[8].

In terms of being an reinsurance intermediary, the reinsurance broker generally is an agent on behalf of reinsureds whereas underwriting agents who enter into some forms of written agreement addressing the scope of their authority are authorised by the reinsurers to evaluate risk and to provide reinsurance cover on the reinsurer's behalf[9]. In this connection, if the reinsurance underwriting agent, also known as a managing general agent (MGA), does not accept risk prudently and tries to maximise the premium flow in order to earn more commissions, it may endanger the financial stability of reinsurers and hence their other ceding insurers.

In this Chapter, special emphasis will be given to the collection of the insurer's monies and reinsurance premiums, and to the selection of reinsurers. Several significant cases of insolvent insurers have involved extensive participation by "reinsurance intermediaries working on commissions, and they have been the chief

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[7] *See generally* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 333-410. *See also* Stephen W. Schwab, Peter G. Gallanis, David E. Mendelsohn, Bradley V. Ritter, *Caught between Rocks and Hard Places: The Plight of Reinsurance Intermediaries Under U. S. and English Law*, 16 MICHIGAN JOURNAL OF INTERNATIONAL LAW 485 (Winter 1995); MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON, & PERTER R. KENSICKI, PRINCIPLES OF REINSURANCE Volume I (July 1995).

[8] The issues relating to accounting treatment of reinsurance intermediary will be discussed below.

[9] *See* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 333. Stephen W. Schwab, Peter G.

conduit for transferring policyholder funds to unsound and unscrupulous destinations around the globe".[10] Furthermore, the use of MGAs by reinsurers to underwrite and to accept risk on their behalf has been proved to be exceedingly dangerous and result in a financial insolvency crisis of US insurers in the 1980s[11].

From the viewpoint of the regulation of reinsurance, it has been observed that "the regulation of reinsurance intermediaries, both in the United States and abroad, is regarded as essential to the preservation of insurance company solvency and the protection of a failed insurer's creditors[12]". In the emerging markets, due to the lack of adequate knowledge and information, insurers rely on reinsurance intermediaries heavily to arrange reinsurance cover and retrocession. This increases the potential risk of financial failure of insurers in these emerging markets. However, a companion dilemma faced by regulators in these countries is that the overly regulation regarding reinsurance intermediaries may potentially impede the liberalisation of the domestic reinsurance business and the diversification of domestic risk. How to apply the developed regulatory models and to take into account particular legal and economic environment is one of the main issues to be addressed in this Chapter.

In terms of reinsurance intermediary regulation, non-common law-based emerging markets may find it difficult to adopt basic common law concepts that underpin the legal aspects of such intermediaries into the existing civil law system, particularly in the field of general law of agency and the concept of self-regulatory

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Gallanis, David E. Mendelsohn, Bradley V. Ritter, *supra* note 7.

[10] Staff of Subcommittee on Oversight and Investigations, House Common on Energy and Commerce, Cong., 2d Sess., Wishful Thinking: A World View of Insurance Solvency Regulation (Comm. Print 1994), p.14., cited by *Id.* at 490.

[11] The report submitted by a Committee of the United States House of Representatives states that "Mission had two subsidiaries... that acted as MGAs on behalf of Mission and its reinsurance pool members. Integrity and Transit used a nationwide system of independent MGAs to write direct business and arrange reinsurance on their behalf. Underpricing and minimal or poor underwriting by their MGAs were leading contributors to the failure of all three companies. Mission, Integrity and Transit were fronts used by their MGAs to write business that was intended to be passed almost 100 per cent to reinsurers... insurance policies can only be legally written in the name of licensed insurance companies,... At least one MGA even created his own private offshore reinsurance companies to capture the bulk of the premiums on the business he wrote for Transit, in addition to receiving commissions for originating and reinsuring the same business. Insurance companies that basically rent their name in a fronting agreement earn a fee, but they risk financial disaster if the reinsurers arranged by the MGAs refuse, or are unable, to pay their share of claims. In that situation, the fronting insurance company with its name on the policies is required to pay 100 per cent of the claims. That is exactly what happened to Mission, Integrity and Transit, and that was the immediate cause of their insolvencies.", in Subcommittee on Oversight and Investigations, House Common on Energy and Commerce, 101 ST CONG., Failed Promises: Insurance Companies Insolvencies (Comm. Print 1990), at 11, cited by P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 412.

[12] Stephen W. Schwab, Peter G. Gallanis, David E. Mendelsohn, Bradley V. Ritter, *supra* note 7, at 487.

organisations delegated by the government.

This Chapter considers the theme of this volume concerning reinsurance intermediaries and their influence on financial solvency and stability of insurers from a comparative analysis of the leading regulation models, so as to establish the appropriate regulatory infrastructure that might best be applied in developing countries such as Taiwan. Section 1 and 2 discusses the general duties of reinsurance intermediaries and addresses the core of regulation of reinsurance intermediaries as well as the relevant regulatory issues. Section 3 then considers several experienced leading regulatory models that provide a more reliable regulatory infrastructure. In conclusion, the author will suggest a possible regulatory infrastructure necessary to maintain financial stability in the emerging insurance/reinsurance market.

I. Reinsurance Intermediaries and Financial Stability of Insurers and Reinsurers

With regard to business practices in the reinsurance market, it has been summarised that the reinsurance broker's functions are to

"advise the reinsured as to a suitable reinsurance programme and ways of improving its current programme, to obtain suitable reinsurers for a long term relationship on the best terms, to negotiate the terms of the reinsurance and to prepare the contract wording, or to ensure that any wording prepared by the reinsurers conforms to the agreed terms, to arrange the collection of claims and payment of premiums, to prepare any records or documentation for use by the reinsured for his accounting requirements or for renewal, and to assist the reinsured generally by using his relationship between the parties to fulfill their agreement to their mutual advantage.[13]" In this section, the legal duties owed by the reinsurance intermediaries to their principals will be addressed. It is followed by the analysis and discussions of the reinsurance intermediary's activities affecting the financial condition of the primary insurers and reinsurers.

The legal duties owed by the reinsurance intermediaries to their principals generally depend on applicable agency, tort, insurance, and insolvency law[14] and on

[13] *See* CHRISTOPHER HENLEY, THE LAW OF INSURANCE BROKING 245 (Longman, London, 1990).

[14] The duty of reinsurance intermediary will also be affected by the equity law in the common law

the contracts between intermediaries and their principals. What follows is an attempt to analyze the general legal duties of reinsurance intermediaries as well as the customary practices in the international reinsurance markets. In addition to legal duties owed by the reinsurance intermediary to their principals, the legal disputes relating to reinsurance intermediaries will also be addressed.

A. To Exercise A Reasonable Skill and Care in Transacting Reinsurance Business

With respect to a reinsurance intermediary's contractual duty to its principals, it is generally agreed that the main contractual duty owed by a reinsurance intermediary is to exercise "reasonable skill and care" in transacting the reinsurance business. However, legal issues often arise from the difficulty in defining what constitutes "reasonable skill and care" in transacting such business.

The intermediaries should exercise "reasonable skill and care" on the placement of reinsurance covers for their principals and on the assessment of accepting risk. The brokers who act as agents of the ceding insurers usually are instructed to obtain available reinsurance coverage for the same risk as the original insurance. If the brokers fail to follow the reinsured's instruction to obtain suitable cover, the broker may be liable for any loss by reason of its failure to observe a degree of reasonable skill and diligence[15]. On the other hand, the underwriting agents should exercise reasonable skill and diligence in accepting insurance risk for the reinsurers. For determination of what constitutes "reasonable skill and diligence", market practices and particular circumstances in each case needs to be taken into account.

In addition, the reinsurance intermediary is under a duty to select a financially solvent reinsurer and to assess the insurance risk that reinsurer intends to assume. In connection with a reinsurance broker, it should carry out a reasonable investigation and analysis into the financial creditworthiness of the reinsurers. Although the broker should not or be liable for every insolvent reinsurers, the broker is under a contractual duty to exercise reasonable skill and care in the selection of reinsurers (i.e., financial viability and the creditworthiness of reinsurers). What constitutes reasonable skill and

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system. P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 333.

[15] The issue of the contractual duties of a reinsurance broker to effect a valid reinsurance was discussed in *National Insurance & Guarantee Corporation plc v. Imperio Reinsurance Co. (UK) Ltd. and Russell Tudor-Price & Co. Ltd.* [1999] Lloyd's Rep IR 249 (QB Com Ct).

care in the selection of reinsurance was considered in the US case of *Cherokee Ins. Co. v. E. W. Blanch Co.*[16]. Here, the court held that the broker followed the customary practice in the industry and, accordingly carried out reasonable skill and care. With regard to the customary industry standard, the court found that the brokers should assess the following factors to meet the industry customary standards. (1) its rating by A. M. Best Company; (2) the size of the reinsurer, as measured by its policyholder surplus; (3) Insurance Regulatory Information System ratios tested by the National Association of Insurance Commissioners; (4) the reinsurer's annual reports; and (5) the reinsurer's reputation in the industry[17]. In other words, what constitutes reasonable skill and care in the selection of reinsurers mainly depends on customary practice unless it has been regulated by specific regulations.

In addition, the broker should exercise reasonable skill and care before the placement of reinsurance covers and remains under a continuing duty to monitor the reinsurer's solvency if the broker has accepted such a responsibility[18].

On the other hand, the underwriting agent is to exercise reasonable skill and care in assessing the assumed risk and in analyzing the potential financial impact on the reinsurer's behalf. If the underwriting agent intends to extend its own profit without considering and assessing the insurance risk prudentially, it may be liable for any loss suffered by the reinsurers. A recent case[19] in the US illustrates that the underwriting agent may be liable for the damages arising from its negligence in the acceptance of insurance risk. As a result of negligence in the acceptance of insurance risks without adequate investigation and assessment of the cedent's underwriting, reporting and claims practices, the court found that the management general agent and its chief executive was liable for the losses suffered by the reinsurers.

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[16] It should be noted that conformity with customary practices is not necessarily conclusive evidence of reasonable care. If the precautions of the brokers are so imperative that customary practices might not be used as to excuse their omission. *See Cherokee Ins. Co. v. E.W. Blanch Co.*, 66 F. 3d 117 (6th Cir. 1995), cert. Denied, 116 S.Ct. 1545 (1996). Cited by Joseph Schiavone, *Recent Issues In US Reinsurance Law*, Current Issues in Reinsurance Contracts, held by Hawksmere, at 15 (25 November 1999, the Brewery, London).

[17] *Cherokee Ins. Co. v. E.W. Blanch Co.*, 66 F. 3d 117 (6th Cir. 1995), cert. Denied, 116 S.Ct. 1545 (1996), p.120.

[18] The broker may be liable to his principal for breach of contractual duty to monitor the solvency of the reinsurer if he has accepted such a responsibility. *See Beck Helicopters Ltd., v. Edward Lumley & Sons* [1964] A. C. 465.

[19] *See Omaha Indem. Co. v Royal Am. Mgrs.* (1991, WD Mo) Docket No. 86- 0422-CV-W-9, 2 Mealey's Reins Rep No. 11, B (re.), cited by GRAYDON S. STARING, LAW OF REINSURANCE § 7:5 (1993).

B. Avoidance of Conflict of Interests and Dual Agent

Due to the complexity of practices in the industry, reinsurance intermediaries may act simultaneously for a reinsured and reinsurer. For example, it was common at Lloyd's that the brokers act as the agents of the underwriter for the purpose of investigating claims while they have been instructed by a reinsured to collect claims[20]. As a result, the reinsurance intermediaries might encounter difficulties arising from a conflict of interest between a reinsurer and a ceding insurer[21].

With regard to general principles of the law of agency, an agent should not act as both parties at the same time without the informed consent of both parties. Without giving full disclosure of the material facts, the brokers would be in breach of their duty to their principals and liable for damage or loss suffered as a consequence of his breach[22]. Therefore, a reinsurance intermediary should make full disclosure of all material facts to both principals to avoid any potential conflict of interests.

C. Retention of Documents by Reinsurance Intermediary and Collection of Claims

In addition to a contractual duty to exercise reasonable skill and care in the placement of risk and selection of reinsurance security, the reinsurance intermediary is under a duty to retain adequate documents for the ceding insurers particularly in the case of collection of claims. For example, it was found essential to retain the relevant policies and details of the reinsurers when the reinsured wants to submit to their reinsurers asbestos-related claims covered by reinsurance policies[23]. Consequently, the question that arises in the relevant cases is whether the broker should be liable for the loss suffered by the ceding insurers as a result of its inability to collect any claims from its reinsurers[24]. It is well established that a broker is under a duty to exercise reasonable

[20] However, it should be noted that this practice has been disapproved. *See Anglo-African Merchants Ltd v. Baryley* [1970] 1 Q. B. 311., cited by P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 379.
[21] It has been observed that the dual agency may arise when a reinsurance intermediary arranges both a reinsurance and a retrocession placement for the same risk. MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON, & PERTER R. KENSICKI, *supra* note 7, at 74. It should be noted, however, that a broker merely acts as an agent of a reinsurer for a retrocession based on another contract. It is doubtful that there is conflict of interest under this circumstance. *See* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 343.
[22] BARLOW LYDE & GILBERT, *supra* note 1, 2-4 (LLP, Service Issue No. 15-1 October 2000). *See also North and South Trust Co. v Berkeley* [1971] 1 W.L.R. 470.
[23] *See Johnston v. Leslie & Godwin* [1995] L.R.L.R. 472.
[24] BARLOW LYDE & GILBER, supra note 1, at 2-22 (LLP, Service Issue No. 4-1 May 1995).

skill and care to retain documents for a reasonable period of time[25]. Due to the lack of specific laws or regulatory controls in most countries, however, it is difficult precisely to define what constitutes "a reasonable period of time" and "reasonable skill and care to retain relevant documents".

The legal issue concerning retention of documents has been examined under the English case law. In *Johnston v. Leslie & Godwin*[26], the plaintiffs (Lloyd's Syndicate 964) claimed damages because the defendants (the syndicate's reinsurance brokers) were unable to locate any documents listing the names of the retrocessionaries. Clarke J held that a broker's duty includes the duty "to exercise all reasonable care and skill in collecting claims when asked to do so"[27]. In order to collect claims from reinsurers, a broker has a duty to take care of relevant documents and to ascertain the names of restrocessionaires. Failing to retain sufficient records from which to identify the retrocessionaires, the broker was in breach of his contractual duty to the reinsureds and consequently may be liable for the loss arising from an inability to collect claims from reinsurers. Although this decision has stated the broker's duty to retain the relevant documents, it is ambiguous to state precisely what constitutes reasonable skill and care in the retention of documents.

D. Transmission and Maintenance of Reinsurance Premium and Claims

A reinsurance intermediary is under a general contractual duty to remit and to maintain the funds from reinsurance premiums and reinsurance payments on behalf of its principal. Due to the complexity of customary practices and the accounting tasks involved, many legal disputes consequently arise. Before defining this duty of a reinsurance intermediary, the question that should first be determined is whose agent is the intermediary when the intermediary holds monies (premiums or claims)[28]. If an intermediary holds monies and then becomes insolvent, the principal entitled to these payments will be liable for the credit risk of its intermediary.

1. Reinsurance premium and the legal duty of reinsurance intermediary

With regard to reinsurance premiums, the reinsurance intermediary is under a contractual duty to transmit these to the reinsurer or otherwise to maintain these

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[25] *Id.* at 2-23.
[26] *Johnston v. Leslie & Godwin* [1995] L.R.L.R. 472
[27] *Johnston v. Leslie & Godwin* [1995] L.R.L.R. 472, p. 477.
[28] P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 462.

premiums for the benefit of the reinsurer. Under agency law principles[29], a reinsurance broker acting as the agent of a ceding insurer is under a duty to transmit the premiums on the ceding insurer's behalf. As a result, when a broker that have received premiums and then become insolvent before transmitting them, the payment made by the ceding insurer is not considered as having been paid to the reinsurer absent any other express or implied agreements or customary practices to the contrary. In other words, the ceding insurer assumes the credit risk of a failure of a reinsurance broker.

It should be noted, however that the customary practice in certain markets is different from the general law of agency mentioned above. At Lloyd's in London, the broker is personally liable to pay premium to a Lloyd's underwriter: any premium paid to the broker is considered as premium paid to the underwriter[30]. In addition to the customary practice at Lloyd's, this same custom in the marine insurance market is codified in section 53(1) of the UK Marine Insurance Act 1906 (MIA 1906):

" Unless otherwise agreed, where a marine policy is effected on behalf of the assured by a broker, the broker is directly responsible to the insurer for the premium, and the insurer is directly responsible to the assured for the amount which may be payable in respect of losses, or in respect of returnable premium."

Without an express or implied agreement stating the obligation of the broker, the section 53(1) of the MIA 1906 can be applied to the marine insurance and related reinsurance outside the Lloyd's syndicates. Although several attempts have been taken by litigants to extend this customary practice to non-marine reinsurance contracts outside the Lloyd's network[31], it is still unclear whether this section can be applied to all reinsurance contract in the London market[32].

In relation to underwriting agents acting on a reinsurer's behalf, an underwriting agent holds the reinsurance premium as a debtor of his principal rather than holding in the trust for the insured. The same agency law principles applies to the

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[29] *See In re Pritchard & Baird, Inc* 8 B. R. 265 (D. N. J. 1980) aff'd, 673 F. 2d 1301 (3d Cir. 1981.) *See also* BARLOW LYDE & GILBER, *supra* note 1, at 2-20 (LLP, Service Issue No. 6, 4 June 1996).

[30] *See generally Edgar v. Fowler* (1803) 3 East. 222; *Edgar v. Bumstead* (1808) 1 Camp. 411; *Power v. Butcher* (1892) 10 B&C 329 at 347. *Cited by* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 462.

[31] *Wilson v. Avec Audio-Visual Equip. Ltd.,* [1974] 1 Lloyd's Rep. 81. Cited by Stephen W. Schwab, Peter G. Gallanis, David E. Mendelsohn, Bradley V. Ritter, *supra* note 7, at 498.

[32] It has been stated that the section 53 (1) of the MIA 1906 applies to facultative but not treaty marine

underwriting agents. As a result, an underwriting agent is personally liable to receive all premiums due to the principal in reinsurance business unless an express provision is contained in the agency agreements.

2. Transmission and maintenance of reinsurance claims

In terms of reinsurance claim monies, the broker, who generally acts as the agent of reinsured in this situation, is personally liable to transfer the claims to his principal. In other words, the payment of claims paid to the brokers is considered as having been paid to the reinsured. In this connection, the reinsured may assume the credit risk of the broker when the broker receives the claims from the reinsurers and then the reinsured fails to instruct the broker to collect the money and to hold these in a trust.

With regard to the underwriting agent, the claim paid to the underwriting agent is not considered as having being paid to the reinsured. As a result, the reinsurers assume the credit risk of the agent.

Where reinsurance intermediary holds large amounts of claims, the potential risk will arise if the intermediary does not exercise "reasonable care" to invest or to operate prudentially. This issue will be addressed in the following section.

II. Regulatory Issues Arising From Reinsurance Intermediary and Financial Solvency of Primary Insurers and Reinsurers

After looking at the general legal duties of reinsurance intermediaries and their impact on the financial solvency of the primary insurers, possible regulatory approaches and the relevant, related regulatory issues will be addressed in this section.

As to general legal duties, the duty of care on the placement of reinsurance cover or on underwriting of risk owed by the reinsurance intermediaries to their principals, as well as the matter of market conduct control, will be discussed. Due to the complexity of reinsurance markets, the competence, integrity and experience of the reinsurance intermediary might be a contributing cause of an intermediary's failure. As a result, the licensing process should contain relevant criteria in considering application for registration or establishment of a reinsurance intermediary.

Furthermore, as an intermediary might maintain the funds from the reinsurance premiums and claims, the solvency of the intermediary becomes a factor

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reinsurance. P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 463.

when evaluating potential risks respecting the solvency of insurer and reinsurer. Therefore, the financial requirement relating to the accounting treatment of and the solvency of the reinsurance intermediary should be applied as a safeguard of solvency of a reinsurer and primary insurer who transact business with an intermediary. In addition to these financial requirements, possible role of compulsory liability insurance, which might be used to cover the intermediary's losses arising from the claims for the breach of duty in connection with the business by reason of any negligent act, error or omission, will be discussed.

A. Duty of Care on the Placement of Reinsurance Cover or Acceptance of Risk for Their Principals

It is generally agreed that reinsurance intermediaries should exercise "reasonable skill and care" in the performance of their function[33] on behalf of reinsurers or reinsured. In terms of reasonable skill and care, the general duty of a reinsurance broker is to obtain the available reinsurance coverage required by the reinsured within a "reasonable time".

However, legal disputes often arise in cases where a reinsurance broker fails to complete the coverage required by the reinsured. In addition to placing the cover to meet the coverage required by the reinsured, the reinsurance broker may have exposed himself to a claim for negligence for failing to select a solvent reinsurer. Although "it is a fundamental principle of the broking industry that brokers do not guarantee the performance of the reinsurers with which they place their client's business,[34]" brokers should be careful to carry out reasonable investigation and analysis to satisfy the legal test of the "reasonably diligent broker".

In the case of underwriting agents, they also should exercise "reasonable skill and care" in assessing and underwriting the insurance risk on the reinsurer's behalf. If an underwriting agent does not accept risk prudentially and tries to maximise its profit

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[33] *Eagle Star Insurance Company Ltd v. National Westminster Finance Australia Ltd.* (1985) 58 A. L. R. p.174. *Challendar v. Oerlichs* (1838) 5 Bing. N.C. 58., cited by P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 333. *See also Commonwealth Insurance Company v. Thomas A. Greene & Co.,* 709 F. Supp. 86, 87 (S.D.N.Y.); *Insurance Co. of Ireland, Ltd. v. Mead Reinsurance Corp.,* No. 88 CIV 8779 (PKL), 1994 WL 605987, at 9 (S.D.N.Y. Nov. 4, 1994); *Insurance Co. of Ireland,* 1994 WL 605987, at 10; *Cherokee ins. Co. v. E. W. Blanch Co.,* 66 F. 3d 117 (6th Cir. 1995); *Master Plumbers Ltd. Mutual Liab. Co. v. Cormany & Bird, Inc.,* 255 N.W.2d 533 (Wis. 1977)., cited by Paul M. Hummer, *Reinsurance Intermeidaries: When are They Liable and to Whom,* Mealey's Litigation Reports: Reinsurance 20, 7 No. 10, (1996).

[34] BARLOW LYDE & GILBER, *supra* note 1, at 2-12 (LLP, Service Issue No. 15, 1 October 2000).

earned from the commission, it might inevitably cause the insolvency of reinsurers or insurers in a case of a retrocession. It is evident that the financial solvency of reinsurers is endangered where the reinsurers were only dependent on an underwriting agent to determine the quality and amount of business accepted by the reinsurers, particularly in the case of a reinsurance pool[35].

Although the legal duties and the obligations of reinsurance intermediaries are determined by relevant law and decisions made by the courts, historical evident shows that the potential risk of the transactions handled by these intermediaries can not be prevented unless appropriate regulatory control has been established and enacted[36]. Therefore, it is important to develop a viable regulatory method to regulate the market conduct of reinsurance intermediaries.

In the UK, it is unclear as to what constitutes "due diligence" in the selection of reinsurers although the broker is under a duty to exercise reasonable skill and care in assessing the creditworthiness of reinsurers[37]. It has been suggested that "the market practice will probably serve as a guide to a court called upon to decide"[38]. With regard to regulatory control, the market conduct of a reinsurance intermediary in the UK are subject to principles and Code of Conduct provided by the self-regulation organisations such as Insurance Brokers Registration Council (IBRC) which has been replaced under the new UK Financial Services and Markets Act 2000 by the General Insurance Standards Council (GISC). Although the Insurance Brokers (Registration) Act 1977 was repealed on 30th April 2001, the Code of Conduct provided by the IBRC is worth noting.

In terms of the "reasonable skill and care" standard in the selection of insurers (reinsurer), the relevant Code of Conduct (which has been replaced by GISC Rules) provides:

"If insurance brokers recommend to a client, or are requested by such a client, to place his insurance with an insurer who is not authorised or permitted to carry on or

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[35] *See generally* Subcommittee on Oversight and Investigations, House Common on Energy and Commerce, 101 ST CONG., Failed Promises: Insurance Companies Insolvencies (Comm. Print 1990), at 10.
[36] *See* below section III A. United States and NAIC Regulation of Reinsurance Intermediary Model Act.
[37] *See Hurrell v. Bullard* (1863) 3 F.& F. 445. Cited by P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 391.
[38] *Id.* at 391.

provide insurance of the relevant class in the UK, great care must be taken to ensure that at the time of recommendation or the request, the client appreciates the possible risks involved and such should be put in writing to the clients if the insurance broker reasonably believes it would be appropriate having regard to the client's experience of insurance."[39]

However, this Code of Conduct only provides relevant principles regarding the selection of reinsurers when insurance brokers request their clients to place their reinsurance with an unauthorised reinsurer. In addition, it is still ambiguous as in defining what constitutes "reasonable skill and care" in the selection of reinsurers and insurers.

B. Competence of Reinsurance Intermediary- Fit and Proper Principles

In addition to the duty of care, a reinsurance intermediary must maintain a thorough knowledge of markets[40] when he places the reinsurance cover, negotiates the reinsurance agreement, transmits the funds and communicates between the parties.

As a result of the necessity to ensure the fitness and propriety of management, the licensing or registration process should contain relevant criteria in considering application for registration or establishment of a reinsurance intermediary. These criteria should take into account the competence, practical experience and suitability of the applicant as the reinsurance intermediaries. For instance, the UK IBRC will consider the qualification[41] of the applicants. The IBRC also approved a list of educational institutions where the applicants can be educated and become as qualified brokers[42]. The appropriate character and the suitability quality of the key staffs also will be taken into account in the registration process[43]. In effect, there are one set criteria to be evaluated in a responsible discretionary setting.

C. Transmission and Maintenance of Funds relating to Premium and Claims-Insurance Money Separation and Accounting

Historical evidence shows that reinsurance intermediary could generate credit risk in

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[39] Insurance Brokers Registration Council (Code of Conduct) Approval Order 1994 (SI 1994/2569), Regulation 2, I, (13).
[40] *See* CHRISTOPHER HENLEY, *supra* note 13, at 245.
[41] Section 3(1) of Insurance Brokers (Registration) Act 1977 (1977 c 46), INSURANCE LAW HANDBOOK 897 (Michael Brown ed., Butterworths, 2000).
[42] Section 6 (1) of Insurance Brokers (Registration) Act 1977 (1977 c 46). *Id.* at 897.
[43] Section 4 of Insurance Brokers (Registration) Act 1977 (1977 c 46). *Id.* at 898.

cases where the funds received from reinsurers and insurers are not prudentially managed[44]. In order to reduce adverse financial impact respecting the solvency of insurers and reinsurers, several regulatory approaches have been undertaken by developed countries. In general, the monies received from premiums and reinsurance claims are segregated from the general accounts of the reinsurance intermediary. In addition, the management of these accounts is limited to specific purposes in connection with the operation of the relevant insurance business.

In the UK, the financial requirement issued by the GISC[45] provide that the reinsurance broker should open its insurance bank accounts (IBAs) for the specific purposes of payments to reinsureds and reinsurers and the operation of the broker's insurance business. The Lloyd's brokers are also subject to similar requirements[46] relating to the IBAs. With regard to the IBAs, the operation of these accounts is limited to specified purposes stated in the IBRC rules. In the US, the NAIC Reinsurance Intermediary Model Act provides that all funds collected on behalf of the insurer must be held by the broker in a fiduciary capacity and must be deposited in a qualified US financial institutions[47].

It should be noted, however, that the financial solvency of the reinsurance intermediary still might impose potential credit risk on its principal in cases where it holds the monies received from the reinsurers and insurers. Without express arrangements and customary practices to the contrary, the reinsurance intermediary does not hold the funds regarding premiums and claims as trustee for the ceding insurer or the primary insurer. Therefore, under the general law of agency, the ceding insurers may be liable for the credit risk of a failed reinsurance broker. By contrary, the reinsurers may bear the financial losses arising from the credit risk of the failure of an underwriting agent where it acts as the agent of the reinsurer.

D. Professional Indemnity Insurance and Solvency of Reinsurance

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[44] *In re Pritchard & Baird, Inc.* 8 B. R. 265 (D. N. J. 1980) aff'd, 673 F. 2d 1301 (3d Cir. 1981.) In this case, the principal owner of the reinsurance intermediary-Pritchard & Baird withdrew large amounts of money estimated as high as $ 40 million from the firm as advances against future earnings As a result of inadequate capital, the intermediary was forced into bankruptcy. *See* MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON, & PERTER R. KENSICKI, *supra* note 7, at 78.

[45] Section G.1, Financial Requirements of General Insurance Standards Council Rules.

[46] Lloyd's Brokers Byelaw No. 5 of 1988. Cited by P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 464.

[47] NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (N. A. I. C.), *Reinsurance: Reinsurance Intermediary Model Act* § 4 (C), in NAIC MODEL LAWS, REGULATIONS AND

Intermediary

Where the reinsurance intermediary holds the monies from premiums and claims and the relationship between the intermediary and the reinsurer or insurer is anything other than that of the debtor and creditor[48], the solvency of the reinsurance intermediary is a vital factor that may affect the financial condition of the reinsurer and primary insurer. Furthermore, the intermediary may be liable for the losses of its principal arising from professional negligence in the placement of reinsurance cover or the acceptance of reinsurance risk. Under such a circumstance, the reinsurance intermediary should not only maintain its own financial solvency and capital adequacy but also hold a certain amount of professional indemnity insurance to meet possible losses from investments, operation of its insurance business, and legal disputes.

In the UK, the new self-regulation orgainisation GISC, in June 2000, issued the financial requirements[49] to ensure the solvency of the intermediary. The GISC considers the possible losses arising from legal liability and requires each member to maintain adequacy professional indemnity cover. In addition to professional indemnity insurance, the GISC requires each member to maintain its financial solvency to meet any foreseeable liabilities.

E. Fronting and Pool Members

An underwriting agent acting as the agent of the reinsurer has the authority to assess and to accept reinsurance risk on behalf of the reinsurer by way of express agreement. In some cases, an underwriting agent who holds binding authority to underwrite reinsurance business may act as the agent of several reinsurers, particularly in a pool. It is common in the international reinsurance markets that several reinsurers act as a pool to accept insurance or reinsurance business. In a pool, the individual members are only liable for their respective proportions of the risk. In order to circumvent the regulator's authorisation and to facilitate transactions, one of the pool members who obtains the authorisation to carry on business can be nominated as the "fronting" company and can legally accept reinsurance risk. In this situation, the underwriting

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GUIDELINES VOL.V, 790-4 (1999).

[48] *See* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 464.

[49] GISC Rules, Section G: Membership Practice Requirements, Practice Requirement G1-Financial Requirements, *supra* note 47, at 1695-1697.

agent will be acting as the agent of the fronting companies to accept risk and then as the agent of the other members to accept the risk assumed by the fronting company[50]. Consequently, legal disputes often arise as to the scope of authority of the underwriting agent and as to the legal liability of pool members.

With regard to legal disputes relating to the authority of the underwriting agent, the underwriting agent may nominate one of the pool members as a fronting company without the authority of all of the pool members. In an English case, *Suncorp Insurance & Finance v. Milano Assicurazioni SpA* [51], the underwriting agent used Milano as a fronting company for the other pool members. Due to lack of express arrangement regarding the delegation of authority to nominate Milano as a fronting company, it was argued that the underwriting agent had inherent authority to use one or more members as the fronting company. However, Milano, having become aware of the fact that its agent had abused their authority, took no step within a reasonable time to notify the third parties. As a result, Waller J. concluded that: "Milano did adopt and intended to adopt the Suncorp contracts, at least to some extent. It thus seems to me on the basis that it is not possible to ratify in part, they have thus ratified the Suncorp contracts"[52]. In other words, an underwriting agent who acts as the agent on behalf of a pool of the reinsurers has no actual authority to use or to nominate one or several pool members as the fronting companies without express provision in the underwriting agreement.

As to legal liability of pool members, the pool members are only liable for their respective proportions of accepted risk. Furthermore, privity of contract only exists between the reinsured and the fronting reinsurer. As a result, it is obvious that the financial solvency of the fronting company will be vulnerable to the insolvency of pool members. Legal disputes may arise where the fronting company is exposed financially in the event of uncollectible claims from other pool members[53]. In some

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[50] *See* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 435.
[51] *Suncorp Insurance & Finance v. Milano Assicurazioni SpA* [1993] 2 Lloyd's Rep 225.
[52] *Suncorp Insurance & Finance v. Milano Assicurazioni SpA* [1993] 2 Lloyd's Rep 225, at 241.
[53] *See Sedgwick Tomenson Inc. v. P. T. Reasuransi Umum Indonesia* [1990] 2 Lloyd's Rep. 334. In this case, Evans J. observed that "The usual form of remuneration for the fronting is an overriding commission, of , say 1 per cent. No one doubts that the name insurer is liable in full to the assured, in accordance with his contract and regardless of the reinsurance arrangements, though in the normal course he would recover an indemnity depending on the terms agreed with reinsurer." In other words, in the event of insolvency of one of pool members, the fronting company who only earns overriding commission is vulnerable to the addition credit risk caused by the pool member. [1990] 2 Lloyd's Rep. 334, p. 341.

cases, the pool members would arrange particular agreements, known as "cross-liability clauses", to provide for the additional liability in the event of the default by some of members[54].

In terms of reinsurance regulation, a fronting arrangement raises considerable concerns from the regulators. Firstly, a fronting arrangement can be used to circumvent the insurance regulation to conduct reinsurance business in the case where some of the pool members do not obtain formal authorisation. Consequently, the primary insurers may have serious difficulty in the collection of reinsurance claims and as to the assessment of the appropriateness of the reinsurance.

Secondly, the solvency of a fronting company may be endangered when the pool members are liable for their respective proportion of insurance risk. This has caused several insolvency cases where reinsurance pool members were dependent on an underwriting agent (managing agent) to determine the quality and the amount of risk assumed by the pool members[55]. If the fronting company fails to exercise appropriate control in the placement of insurance risks and in the collection of claims, the financial difficulty of the fronting company consequently may affect the ceding insurer.

In the US, attempts to regulate these controversial arrangements have been undertaken by the National Association of Insurance Commissioners (NAIC). In 1993, the NAIC adopted a Model Law requiring the reporting and prior approval of these activities. Due to insurer's opposition and complexities in the reinsurance markets[56], however, no state yet has adopted this model law. Alternatively, the NAIC adopted, in 1995, a revision to its Schedule F of the Annual Statement to require ceding insurers to disclose whether they have reinsurance contracts ceding 75 percent or more of direct written premiums[57].

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[54] *See generally* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 437-440.
[55] *See generally* Subcommittee on Oversight and Investigations, House Common on Energy and Commerce, 101 ST CONG., Failed Promises: Insurance Companies Insolvencies (Comm. Print 1990), at 4-39.
[56] It is difficult to find a common approach to regulate such abuse without increasing considerable transaction costs and difficulties as to implement. For instance, one of the main purposes of this regulation is to restrict a licensed insurer from fronting for an unlicensed one. However, these measures may consequently prevent a licensed reinsurer from reinsuring business from a non-licensed insurer. Such a restriction may have a significant impact on the reinsurance market, particularly on the professional reinsurers who accept reinsurance risk internationally. *See* Reinsurance Association of America, *Fronting*, (17 August 2001), at <http://www.raanet.org/policyupdate/fronting.html>.
[57] *Id.*

III. Leading Regulatory Models and Recent Developments

In developing a viable regulatory approval for emerging markets, the leading regulatory models both in the United States and the United Kingdom are worth examining. In this connection, these developed models and the extent to which other historical precedents and specific legal issues may be of assistance in setting up a viable regulatory model will be noted.

A. United States and NAIC Regulation of Reinsurance Intermediary Model Act

Insurance companies in the United States had suffered a financial solvency crisis during the 1980s. In 1990, a report submitted by the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, chaired by Congressman John D. Dingell, made the following observation on insurer insolvencies relating to reinsurance intermediaries:

"1. The crucial process of selecting dependable reinsurers is left to the unfettered discretion of insurance company managers.

2. No one seems to know where the reinsurance chain goes or whether its links are all around.

3. Managing general agents are delegated many of the basic insurance functions including the placement of reinsurance.

4. Reinsurance pool members are dependent on (a) managing agency to determine the quality and amounts of business accepted by (the) reinsurance pool.

5. The slow payment of insurance and reinsurance proceeds threatens the fragile chain of financial stability in reinsurance relationships.

6. A managing general agent's authority is difficult to terminate because the contracts typically provide for 90 to 180 days prior notice with the agent continuing to write more under-priced business until the end of this notice period.

7. Agents frequently appoint subagent with little or no control by the company.

8. Reinsurance intermediaries and underwriters often fail to inquire into the

combined ownership of the managing general agent (representing the primary insurer) and the reinsurer.[58]"

Four years later, the House Subcommittee issued a report entitled "Wishful Thinking: A World View of Insurance Solvency Regulation"[59] which concluded that federal intervention and the implementation of appropriate regulatory systems to prevent insolvency is needed. With regard to reinsurance intermediaries, the Subcommittee recommended that the regulators should "closely inspect the qualifications and activities of independent brokers and agents, especially those handling reinsurance and surplus line coverage"[60].

Following the publication of this report, a number of steps were taken by several states regulators and the NAIC, with a view to improving the regulatory system for preventing another insolvency crisis. Furthermore, the failure of a reinsurance intermediary, Pritchard and Baird (P&B) had the effect of requiring the regulators to regulate reinsurance intermediaries' activities.

1. *Pritchard & Baird* decision and the Intermediary Clause

The case of *In re Pritchard & Baird, Inc.*,[61] involved a dispute over whether a reinsurance intermediary acting as the agent of insurer or reinsurer and the ceding companies have claims against assets of the intermediary's estate for the transmitted premiums. In this case, the reinsured Hartford Fire Insurance Company and Hartford Accident and Casualty Company remitted reinsurance premiums to the Intermediary, P&B, for transmittal to the reinsurer. However, the intermediary went bankrupt and the premiums were never been transmitted to the reinsurers. On the one hand, if P&B were the agent of the reinsurers, the premiums paid by the Hartford would constitute payment to the reinsurer. On the other hand, the reinsurer would have a claim against the assets of the bankrupt estate for the premiums transmitted to P&B if P&B was the agent of the insurer, Hartford. As a result, both sides argued over the scope of

[58] *See* Subcommittee on Oversight and Investigations, House Common on Energy and Commerce, 101 ST CONG., Failed Promises: Insurance Companies Insolvencies (Comm. Print 1990), at 4-39, cited by Debra J. Hall, *The Emerging Regulation of Reinsurance Intermediaries*, 42 DRAKE LAW REVIEW 859, 861(1993).

[59] Staff of Subcommittee on Oversight and Investigations, House Common on Energy and Commerce, 103d Cong., 2d Sess., Wishful Thinking: A World View of Insurance Solvency Regulation (Comm. Print 1994), cited by Stephen W. Schwab, Peter G. Gallanis, David E. Mendelsohn, Bradley V. Ritter, *supra* note 7, at 490.

[60] *Id.* at 490.

[61] 8 B. R. 265 (D. N. J. 1980) aff'd, 673 F. 2d 1301 (3d Cir. 1981.)

authority of P&B for determining which party should bear the ultimate loss of failure of P&B.

Based on P & B's operating practice that the ceding insurer has the ultimate authority to accept or to reject reinsurance contracts, the United States District Court for the District of New Jersey held that the cedent *de facto* controlled the intermediary and that an agency relationship existed between ceding companies and intermediary rather than between intermediary and reinsurers[62]. As a result, the premium paid by the ceding insurer to the intermediary did not constitute payment to the reinsurer. Accordingly, the reinsurance payments paid by reinsurers should be deemed as payment to the ceding insurer if the reinsurance intermediary is the agent of the ceding insurer. In other words, the ceding insurer assumed the credit risk of the intermediary relating to payments to the intermediary.

In order to reduce legal disputes arising as to the authority of the reinsurance intermediary and to ensure the financial stability of the ceding insurer, the NAIC enacted a model regulation to clarify the liability of the intermediaries to the ceding insurers and reinsurers relating to these payments. This has been amended in the NAIC *Examiner's Handbook*[63], with this "intermediary clause" placing the credit risk on the reinsurer in a reinsurance transaction. Otherwise, the insurer cannot take statutory reinsurance credit to reduce its loss reserves. A typical "intermediary clause" relating to payments reads as follows: "...... Payments by the Company to the Intermediary shall be deemed to constitute payment to the reinsurer. Payments by the reinsurer to the Intermediary shall be deemed to constitute payment to the Company only to the extent that such payments are actually received by the Company[64]"

Although this clause requires the reinsurer to assume all the credit risk regarding the payment paid by the reinsurer and insurer, the intermediary is deemed the agent of the reinsurer only for the purposes of receiving and transmitting monies.

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[62] The court considered the following factors:
(1) the term and conditions of the reinsurance treaty were set by the reinsured; (2) the reinsured made the premium check payable to the reinsurance intermediary; (3) the intermediary then distributed the premiums to the reinsurers, less its commissions; (4) the reinsurer wrote less checks payable to the reinsured directly, instead of the intermediary; and (5) the reinsured did not delegate any authority to the reinsured." 8 Bankr.265 (D. N. J. 1980), p.270., cited by ROBERT W. HAMMESFAHR & SCOTT W. WRIGHT, THE LAW OF REINSURANCE CLAIMS 262 (Reactions Publishing Group, 1994).

[63] NAIC, National Association of Insurance Commissioners Examiners Handbook 5-9 (1994).

[64] *See* Marilyn J. Laughlin, *General Clauses for All Treaties*, REINSURANCE CONTRACT WORDING, at 102 (Robert W. Strain ed., 1996).

Therefore, it should be noted that the question of whose agent the reinsurance intermediary is should be decided by the basic legal principles of agency[65].

2. National Association of Insurance Commissioners

In 1976, New York was the first state to require the licensing of reinsurance intermediaries, enacting Section 122-a of the New York Insurance Code[66]. This was followed by Regulation 98, which mandated several significant changes as to intermediary conduct. Regulation 98 generally requires as to reinsurance intermediaries:

(1) a written authorisation from a ceding insurers; (2) notification regarding a reinsurance agreement for the cedents; (3) to provide information relating to financial condition for their principals; (4) avoidance of the conflict of interest between the reinsurers and insurers; (5) obligation to maintain books and records of reinsurance transactions, (6) to create separate accounts for their principals monies[67].

In 1993, the NAIC Reinsurance Intermediary Model Act was adopted by the National Association of Insurance Commissioners to govern reinsurance intermediaries, including reinsurance brokers and agents of reinsurers, known as Managing General Agents (MGAs). This Model Act, addressing the earlier report, "Failed Promises: Insurance Companies Insolvencies", mainly focused on the reinsurance brokers (RBs) and reinsurance managers (RMs) respectively. The Model Act contains specific provisions including licensure of reinsurance intermediaries, required contract provisions between the intermediaries and their principals, prohibited acts of the reinsurance managers, and duties of insurers or reinsurers utilising the services of a reinsurance intermediary including brokers and managers. Till now, statutes based on this Model Act have been adopted in whole or a modified form by nearly all states in the US[68].

a. The scope of Reinsurance Intermediary Model Act

The NAIC Reinsurance Intermediary Model Act categorises reinsurance

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[65] *See generally* Paul M. Hummer, *supra* note 33.

[66] New York Insurance Law section 122-a (McKinney Supp. 1984-85), as amended by New York Law section 2106 (McKinney 1984)., cited by Stephen W. Schwab, Peter G. Gallanis, David E. Mendelsohn, Bradley V. Ritter, *supra* note 7, at 514.

[67] N.Y. Comp. Codes R. & Regs., tit. 11, s32 (1983)., cited by *Id.* at 514.

[68] *See* Mason & Pfeifer, *A Closer Look at Facultative Reinsurance*, 31 Tort & Insurance Law Journal 641, 650 n.56 (1996), collecting state statues, cited by GRAYDON S. STARING, *supra* note 19, § 5:5

intermediaries into "reinsurance brokers" and "reinsurance managers". It defines a reinsurance broker as "any persons, other than an officer or employee of the ceding insurer, firm, association or corporation who solicits, negotiates or places reinsurance cessions or retrocessions on behalf of a ceding insurer without the authority or power to bind reinsurance on behalf of such insurer[69]." The definition of a reinsurance manager is any person, firm, association or corporation who has authority to bind or to manage all or part of the assumed reinsurance business (including the management of a separate division, department or underwriting office) and act as an agent on behalf of a reinsurance[70]. The following persons, however, are excluded from the definition of "reinsurance manager": "(1) An employee of the reinsurer. (2) A U.S. Manager of the United States branch of an alien reinsurer. (3) An underwriting agent which managers all or part of the reinsurance operations of the reinsurers, is under common control with the reinsurance, subject to the Holding Company Act, and whose compensation is not based on the volume of premium written. (4) The manager of a group, association, pool or organisation of insurers which engage in joint underwriting or joint reinsurance and who are subject to examination by the (Insurance Commission) of the state in which the manager's principal business office is located.[71]"

b. Licensure of reinsurance intermediary

In a state following the Model Act, a reinsurance broker or reinsurance manager who wishes to carry on business should be a "licensed producer" in the state. If a broker or reinsurance manager wishes to carry on business in another state, it should obtain license in that state or another state, which has a law substantial similar to this law or such a broker or manager should be licensed in this state as a "nonresident reinsurance intermediary"[72]. With respect to the protection of the reinsurer, the reinsurance manager may be required by the state Insurance Commissioner to file a bond for the protection of the reinsurance and to maintain an "errors and omissions" policy in a set amount[73].

(1993).

[69] *Reinsurance: Reinsurance Intermediary Model Act* § 2.F., *supra* note 47, at 790-1.

[70] *Reinsurance: Reinsurance Intermediary Model Act* § 2.G., *id.* at 790-2.

[71] *Reinsurance Intermediary Model Act* § 2. G. *Id.*

[72] *Reinsurance: Reinsurance Intermediary Model Act* § § 3. A. (1) and (2) B. (1), (2) and (3), *id.* at 790-2, 790-3,

[73] *Reinsurance: Reinsurance Intermediary Model Act* § 3. C. (1) and (2), *id.* at 790-3.

The Reinsurance Intermediary Model Act, however, does not provide the detailed requirements relating to licensing procedure and professional standards for the reinsurance intermediaries. These standards mainly depend on the Commission's discretionary judgement.

c. *Required contract provision and transactions between reinsurance intermediary and its principal*

Under the Model Act, transactions between a reinsurance intermediary and the insurer it represents are to be based on a written authorisation addressing the responsibility of each party.

In respect of reinsurance brokers, authorisation is required to contain a provision on the insurer's right to terminate the RB's authority, the RB's duty to maintain a complete record of related documents, the security of payment from reinsurers and retrocession[74]. In order to ensure accountability and the right of the recourse, the provision should provide that the insurer has a right to terminate the RB's authority at any time[75]. With regard to accounting and other related documents, the provision of the contract is to provide that the RB shall give the reinsurers access to all relevant accounts and books, including information necessary to support all commission, charges and other fees received by, or owing, to the RB, and shall remit all funds due to the insurer within 30 days of receipt. Additionally, the RB is to keep a complete record for each transaction for at least 10 years after expiration of each contract[76]. In order to ensure the security of payment from reinsurer, the RB is to hold all funds collected for the insurer's account in a fiduciary capacity in a qualified US financial institution. In relation to retrocession, the RB is to comply with the written standards established by the insurer for the cession or retrocession of all risk and will

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[74] *Reinsurance: Reinsurance Intermediary Model Act* § 4., *id.* at 790-4.

[75] Debra J. Hall, *supra* note 58, at 869.

[76] The record for each transaction includes: "(1) the type of contract, limits, underwriting restrictions, classes, or risks and territory, (2) period of coverage, including effective and expiration dates, cancellation, provisions and notice required of cancellation; (3) Reporting and settlement requirements of balances; (4) Rate used to compute the reinsurance premium; (5) Names and address of assuming reinsurers; (6) Rates of all reinsurance commissions, including the commissions on any retrocessions handled by the RB; (7) Related correspondence and memoranda; (8) Proof of placement; (9) Details regarding retrocessions handled by the RB including the identity of retrocessionaires and percentage of each contract assumed or ceded; (10) Financial records, including but not limited to, premium and loss accounts; and (11) When the RB procures a reinsurance contract on behalf of a license ceding insurer: (a) Directly from any assuming reinsurer, written evidence that the assuming reinsurer has agreed to assume the risk; or (b) If placed through a representative of the assuming reinsurer, other than an employee, written evidence that such reinsurer has delegated binding authority to the representative."

disclose to the insurer any relationship with any reinsurer to which business will be ceded or retroceded."

With regard to RMs, a transaction between a RM and a reinsurer also is required to be entered into pursuant to a written contract that specifies the responsibilities of each party and that is approved by the reinsurer's Board of Directors. The contract, at least, needs to contain provisions respecting the reinsurer's right to terminate the authority of the RM, RM's duty regarding related to accounts and documents, and the security of the funds for the reinsurer's account[77].

d. Prohibited acts of reinsurance managers

As mentioned above, the activities of the reinsurance managers (also known as MGAs) can also affect the financial stability of reinsurers. It has been identified that the cause of three significant insolvencies in the 1980s was related to the delegation of underwriting authority to the RM. The NAIC Model Act addressed these issues relating to the RM containing the provisions that prohibit reinsurance managers from engaging in specified acts that may be beyond the reinsurer's control. With regard to retrocessions, the RMs are prohibited from ceding retrocession on behalf of the reinsurer unless this is in pursuant to obligatory facultative agreements containing specified guidelines[78]. Furthermore, the RM is also prohibited from collecting any payment from a retrocessionaire or committing the reinsurer to any claim settlements with a retrocessionaire without prior approval of the reinsurers[79]. In order to ensure the reinsurer's control on the RM and to prevent legal dispute arising as to the authority of the RM to act on the behalf of the reinsurer, the RM is not to pay or to commit the reinsurer to pay any claim, net of retrocessions, without approval of the

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Reinsurance: Reinsurance Intermediary Model Act § 5. *Id.* at 790-4, 790-5.

[77] "A. The reinsurance may terminate the contract for cause upon written notice to the RM. The reinsurance may immediately suspend the authority of the RM to assume or cede business during the pendency of any dispute regarding the cause for termination.
B. The RM will render accounts to the reinsurer accurately detailing all material transactions, including information necessary to support all commissions, charges and other fees received by, or owing to the RM, and remit all funds due under the contract to the reinsurer or not less than a monthly basis.
C. All funds collected for the reinsurer's account will be held by the RM in a fiduciary capacity in a qualified US financial institutions. The RM may retain no more than three months estimated claims payments and allocated loss adjustment expenses. The RM shall maintain a separate bank account for each reinsurer that it represents." *Reinsurance: Reinsurance Intermediary Model Act* § 7., *id.* at 790-6, 790-7.

[78] "---. Such guidelines shall include a list of reinsurers with which such automatic agreements are in effect, and for each such reinsurer, the coverages and amounts or percentages that may be reinsured, and commission schedules." *Reinsurance: Reinsurance Intermediary Model Act* § 8 A., *id* at 790-8.

[79] *Reinsurance: Reinsurance Intermediary Model Act* § 8 E., *id.* at 790-8.

reinsurer[80]. In addition, the RM is prohibited from committing the reinsurer to participate in reinsurance syndicate and appointing a sub-RM[81].

e. Duties of insurers and reinsurers utilizing the services of a reinsurance intermediary

While the reinsurance intermediary is subject to the provisions required by the Model Act, the regulatory objectives can not be achieved unless the principal of the reinsurance intermediary exercises "reasonable care" to delegate its authority. As a result, the Model Act contains a provision requiring that an insurer or reinsurer engage the services of person who is licensed in accordance with this Model Act[82] and obtain a copy of the reinsurance brokers' or managers' financial statement[83]. In addition to RM's financial statement, the reinsurer annually needs to obtain the opinion of an actuary attesting to the adequacy of the loss reserves established by a RM[84]. In order to ensure the independence of the RB, an insurer may not employ an individual who is employed by a broker associated with the transaction unless such a broker is under common control with the insurer[85]. With regard to a RM, a reinsurer is required to vest binding authority for all retrocessional contracts or participations in a reinsurance syndicate with an officer of the reinsurer who is not affiliated with the RM[86]. Additionally, reinsurers are prohibited from appointing to its board of directors, any officer, director, employee, controlling shareholder or subproducer of its RM unless their relationships is governed by the federal Holding Company Act or the Broker Controlled Insurer Act[87]. The reinsurer is also required to provide written notification to the state Insurance Commissioner if a contract with a reinsurance manager is to be terminated[88].

B. European Union Directives

In 1976, the EC Insurance Intermediaries Directive of 13th December 1976 was

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80 "...... that exceeds the lesser of an amount specified by the reinsurer or one percent of the reinsurer's policyholder's surplus as of December 31 of the last complete calendar year." *Reinsurance: Reinsurance Intermediary Model Act* § 8 D., *id.* at 790-8.
81 *Reinsurance: Reinsurance Intermediary Model Act* § 8 B & G. *Id.* at 790-8.
82 *Reinsurance: Reinsurance Intermediary Model Act* § § 6 (A) & 9 (A). *Id.* at 790-5, 790-9.
83 *Reinsurance: Reinsurance Intermediary Model Act* § 6 (C) & 9(B). *Id.* at 790-5.
84 *Reinsurance: Reinsurance Intermediary Model Act* § 9 (C). *Id.* at 790-9.
85 *Reinsurance: Reinsurance Intermediary Model Act* § 6 (B). *Id.* at 790-5.
86 *Reinsurance: Reinsurance Intermediary Model Act* § 9 (D). *Id.* at 790-9.
87 *Reinsurance: Reinsurance Intermediary Model Act* § 9 (F). *Id.* at 790-9.
88 According to this Model Act § 7, the transaction between a RM and the reinsurer shall be filed with the Commissioner for approval. As a result, the termination of such a contract is required to notify the

adopted to facilitate the freedom of services for insurance intermediaries, including reinsurance intermediaries. Because the creation of a single internal market and the freedom of services within the EC/EU should result in an extensive range of insurance products, "the policyholders will be even more dependent on the professional competence of the insurance intermediaries[89]". As a result, it is essential to promulgate a comprehensive statutory framework to ensure the professional competence and financial solvency of insurance intermediaries. In 1991, the EC Commission issued Commission Recommendation (92/48/EEC)[90] to "ensure that all member states establish the exact level of general, commercial and professional knowledge considered appropriate to guarantee that the policyholders and persons seeking insurance will be adequately informed and assisted, taking into account the type of intermediary involved.[91]"

Article 3 of this Recommendation contains the following levels of disclosure regarding the independence of insurance intermediaries: "to person seeking insurance or reinsurance of risks, any direct legal or economic ties to an insurance undertaking or any shareholdings in or by such undertakings which could affect the complete freedom of choice of insurance undertaking, and to a compete body, as determined by the member state, the spread of business with different insurance undertakings over the previous year"[92].

In order to ensure that intermediaries will be subject to certain professional standards and registration requirements, the Commission recommended that member states establish an appropriate regulatory regime including the requirements of professional competence of knowledge and ability for the different categories of intermediary,[93] the possession of professional indemnity insurance or other comparable guarantees against liability arouse from professional negligence[94], "fit and

Commissioners. *Reinsurance: Reinsurance Intermediary Model Act* § 9 (E). *Id.* at 790-9.

[89] *See* T. HENRY ELLIS & JAMES A. WILTSHIRE, REGULATION OF INSURANCE IN THE UNITED KINGDOM AND IRELAND A.5.2-01 (Issue 33).

[90] Commission Recommendation on Insurance Intermediaries, 92/48/EEC, 1992 O.J. (L.19).

[91] *See* T. HENRY ELLIS & JAMES A. WILTSHIRE, *supra* note 89, at A. 5.2-01. (Issue 33).

[92] *See id.* at A.5.2-02.

[93] The level of such knowledge and ability is to be determined by the member states. Furthermore, such levels and their practical application may be determined and administrated by professional organisations recognised by a member state or by an insurance undertaking assuming responsibility and liability for the activities exercised by the category of intermediary. *See generally* Professional Requirements and Registration of Insurance Intermediaries, Commission Recommendation on Insurance Intermediaries, art. 4(2), 92/48/EEC, 1992 O.J. (L.19), Annex.

[94] In order to protect the interests of policyholders and ceding companies, an insurance intermediary

proper" persons,[95] and the maintenance of financial solvency[96]. In addition to these professional standards, the Commission recommended that member states should be compulsory registration of insurance intermediaries in each member state (in the Article 5). Insurance intermediaries are also required to inform the public of the fact that they have been registered. Once a central registration exists, this should be able to distinguish between independent and dependent insurance intermediaries. Co-operation between member states in obtaining access to national insurance intermediaries should be enhanced. In member states, adequate sanctions and measures should be established and applied to any unregistered person conducting the business of an insurance intermediary and to those who violate any of the professional competence standards.

Following Commission Recommendation 1991, the Commission in 2000 has published the proposal for the directive addressing insurance mediation including reinsurance mediation and reinsurance intermediaries[97].

This proposal extends the scope of the regulatory regime relating to insurance intermediary and insurance mediation[98]. With regard to reinsurance mediation, it provides that "reinsurance mediation" means the activities "of introducing, giving information, proposing or carrying out work preparatory to the conclusion of contracts of insurance, or in assisting in the administration and performance of such contracts,

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should possess professional indemnity insurance or any other comparable guarantee against liability arising from professional negligence, unless such insurance is already provided for by an insurance undertaking or other undertaking by which he is employed or for which he is empowered to act. *See generally* Professional Requirements and Registration of Insurance Intermediaries, Commission Recommendation on Insurance Intermediaries, art. 4 (3), *id.*.

[95] The member state should impose requirements evidencing good reputation of insurance intermediary. *See generally* Professional Requirements and Registration of Insurance Intermediaries, Commission Recommendation on Insurance Intermediaries, art. 4 (4). *Id.*

[96] Intermediaries may be required to demonstrate financial capacity. The level and form of capital required to do this by the member states is also provided. *See generally* Professional Requirements and Registration of Insurance Intermediaries, Commission Recommendation on Insurance Intermediaries, art. 4 (5). *Id.*

[97] Proposal for a Directive of the European Parliament and of the Council on Insurance Mediation (COM (2000) 511 final) (200/213/EC), OJ 2001, C 29E/245.

[98] The provision of this Directive should be applied to the persons carrying on insurance mediation unless the following conditions are met: (a) the contracts do not require general or specific knowledge of insurance; (b) the contracts are not life insurance contracts; (c) the insurance does not cover any liability risk; (d) the principal professional activity of the person is other than insurance mediation; (e) the insurance is ancillary to the good or service supplied, in particular where such insurance covers either the risk of breakdown, loss of or damage to goods supplied by that person or an indemnification of goods linked to the travel booked with that person; (f) the amount of the premium does not exceed EUR 1000 and the duration of the insurance contract is less than a year." *See* Proposal for a Directive of the European Parliament and of the Council on Insurance Mediation, art. 1(2).

particularly in the event of a claim"[99].

In comparison with the Commission Recommendation 1991, the 2000 proposal provides and detailes the requirements that relate to professional indemnity insurance with certain limitation and financial solvency of intermediaries. The amount of professional indemnity insurance with a limit of indemnity should be at least EUR 1 million per claim "unless such insurance or comparable guarantee is already provided by an insurance undertaking, reinsurance undertaking or other undertaking on whose behalf the insurance or reinsurance intermediary is acting or for which the insurance or reinsurance intermediary is empowered to act"[100].

Furthermore, member states are required to take "necessary action to protect customers against the inability of the insurance or reinsurance intermediary to transfer the premium to the insurance or reinsurance undertaking or to transfer the amount of claim to the insured"[101]. The required amount of capital should be 8% of the premium income, with a minimum of EUR 15,000[102] unless one of the following requirements have been established: "

(1) provisions laid down by law whereby monies paid by the customer to intermediary are treated as having been paid to the undertaking, whereas monies paid by the undertaking to the intermediary are not treated as having been paid to the customer until the customer actually receives them;

(2) customer's monies shall be transferred via strictly segregated client accounts and that these accounts shall not be used to reimburse other creditors in the event of bankruptcy;

(3) a guarantee fund has been set up on behalf of the customer"[103].

To maintain the independence of insurance intermediary, it also sets out several information requirements[104] which should be provided by the insurance

[99] Proposal for a Directive of the European Parliament and of the Council on Insurance Mediation, art. 2 (4).
[100] Proposal for a Directive of the European Parliament and of the Council on Insurance Mediation, art. 4 (3).
[101] Proposal for a Directive of the European Parliament and of the Council on Insurance Mediation, art. 4(4).
[102] Proposal for a Directive of the European Parliament and of the Council on Insurance Mediation, art. 4(4)b.
[103] Proposal for a Directive of the European Parliament and of the Council on Insurance Mediation, art. 4 (4) (a), (c) and (d).
[104] "an insurance intermediary shall provide the customer with at least the following information:

intermediary. It is likely that the Commission will adopt this 2000 proposal and issue another Insurance Mediation Directive, which also would cover reinsurance intermediaries[105].

C. Regulatory Regime in the United Kingdom

The first step in the UK toward regulating insurance intermediary was taken by the National Consumer Council in 1970s. That was followed by the enactment of the Insurance Broker (Registration) Act 1977 and the Insurance Company Act 1982. The Insurance Broker (Registration) Act 1977 established the Insurance Brokers Registration Council (IBRC), which was responsible for registering all those conducting the business of insurance brokers and their professional competence standards. The regulatory system was accomplished through the adoption and implementation of various statutory instruments issued by the IBRC [106] including

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(a) his identity and address;
(b) whether he advises the customer on insurance cover from a broad range of insurance undertakings or not. In the latter case, the insurance intermediary shall also inform the customer of the number and identity of the insurance undertakings with which he may and does conduct business for each class of risk;
(c) any holding, direct or indirect, by the insurance intermediary representing more than 10% of the voting rights and of the capital in an insurance or reinsurance undertaking and of any holding, direct or indirect, by an insurance undertaking, reinsurance undertaking or parent undertaking of an insurance or reinsurance undertaking representing more than 10% of the voting rights and of the capital in the insurance intermediary;
(d) any contractual obligation to conduct the respective business with one or more insurance undertakings as well as the names of those undertakings;
(e) the party to be held liable for any negligence, misconduct or inappropriate advice by the intermediary in relation to the insurance mediation;
(f) the facility referred to in Article 8 allowing customers and other interested parties to register complaints about insurance and reinsurance intermediaries and, if appropriate, about the out-of-court complaint and redress procedures referred to in Article 9;
(g) the register in which they have been included and the means for verifying that they have been registered". Proposal for a Directive of the European Parliament and of the Council on Insurance Mediation, art. 10.

[105] *See* Europa Internal Market, "Insurance Commission Welcomes Council Common Position on Proposed Insurance Mediation Directive", <europa.eu.int/comm/internal_market/en/finances/ins/02-432.htm> (last visited 15 May 2002).

[106] The IBRC established the requirements for registration of individual insurance brokers and reinsurance brokers carrying on their own business in the United Kingdom. The statutory instruments governing reinsurance intermediaries in the United Kingdom can be summarised as follows:
1) Registration and Enrolment-the Insurance Brokers Registration Council (Registration and Enrolment) Rules Approval Order 1978, SI 1978/1395.
2) The Investigating Committee and the Disciplinary Committee- the Insurance Brokers Registration Council (Constitution of the Investigating Committee) Rules Approval 1978, SI 1978/1456, the Insurance Brokers Registration Council (Constitution of the Disciplinary Committee) Rules Approval 1978, SI 1978/1457, the the Insurance Brokers Registration Council (Procedure of the Disciplinary Committee) Rules Approval 1978, SI 1978/1458, the Insurance Brokers Registration Council (Disciplinary Committee) Rules Approval 1978, SI 1978/1503.
3) Professional indemnity insurance and compensation- the Insurance Brokers Registration Council (Indemnity Insurance and Grants Scheme) Rules Approval Order 1987 SI 1987/1496 and the Insurance

registration and training of insurance brokers, regulation of conducts, disciplinary proceedings, the structure of Committees of the Council, and the restriction on the use of titles and descriptions. Although the IBRA have been repealed by the Financial Services And Markets Act 2000 after the establishment of the Financial Services Authority, the statutory instruments issued by the IBRC are still worth noting for facilitating a comparative analysis on the regulation of reinsurance intermediaries.

1. Registration of reinsurance brokers

The original Insurance Brokers Registration Council was to establish and to maintain a register of insurance brokers carrying on the business in the title of the insurance "Brokers"[107]. To qualify as an insurance broker, the broker had to hold a qualification approved or recognised by the Council, or meet the requirements set our in the EC Council Directive 77/92/EEC in the specific period[108]. In addition to the registration of brokers, the IBRC was to be responsible for the supervision of educational institutions and qualifying examinations[109]. With regard to the refusal to register as a broker, the IBRC are required to give the applicants an opportunity of appealing before and being heard by a committee of the Council. If the Council refuses such applications, the applicants can appeal against the refusal of the Council to the Court

Brokers Registration Council (Indemnity Insurance and Grants Scheme) (Amendment) Rules Approval Order 1990, modifying earlier rules made in 1979.

4) Accounting and business requirements-the Insurance Brokers Registration Council (Accounts and Business Requirements) Rules Approval Order1979, SI 1979/489.

5) Use of the title "insurance broker"-the Insurance Brokers (Registration) Act 1977(Commencement No. 3) Order 1980.

6) Authorisation to carry on investment business-the Insurance Brokers Registration Council (Conduct of Investment Business) Rules Approval Order 1996, Council (Conduct of Investment Business) Rules Approval Order 1996, SI1996/1151.

It should be noted that the Insurance Brokers Registration Council (Conduct of Investment Business) Rules Approval Order 1988 is "the means by which insurance brokers carrying on some life assurance or unit trust business can secure authorisation under the Financial Services Act 1986". *See* T. HENRY ELLIS & JAMES A. WILTSHIRE, *supra* note 89, at A1.1-02 (Issue 65 August 2000). With regard to the FSA, the UK government announced that the FSA would extend its powers to include the sale of general insurance/reinsurance product. In addition, from around mid-2004, all those who sell general insurance/reinsurance will be required to obtain the authorisation from the FSA and will be required to comply with relevant business standards provided by the FSA Handbook. Financial Services Authority, Mortgage and General Insurance Regulation: A Guide for Firms, (March 2002)(last visited 15 May 2002) <www.fsa.gov.uk/mort_gen_ins/ins_reg.pdf>.

[107] "The Council shall establish and maintain a register of insurance brokers containing the names, addresses and qualifications, and such other particulars as may be prescribed, of all persons who are entitled under the provisions of this Act to be registered therein and apply in the prescribed manner to be so registered." Section 2 of Insurance Brokers (Registration) Act 1977 (1977 c 46), *supra* note 47, at 897.

[108] Section 3(1) of Insurance Brokers (Registration) Act 1977 (1977 c 46), *id.* at 897.

[109] Section 7 of Insurance Brokers (Registration) Act 1977 (1977 c 46), *id.* at 900.

who may make order and its order shall be the final one[110].

2. The Code of Conduct and conduct of intermediaries

In relation to the conduct of business of reinsurance intermediaries, the IBRC issued the Code of Conduct[111] establishing several fundamental principles addressing the market conduct of brokers now reissued by the GISC Rules. These principles regard the relationship between consumers and brokers as follows: "a) A Insurance brokers shall at all time conduct business with utmost good faith and integrity. b) Insurance brokers shall do everything possible to satisfy the requirements of clients and shall, subject to principle C, place the interests of clients before all other considerations. Subject to these requirements and interests, insurance brokers shall have proper regard for others. c) Insurance brokers shall not directly or indirectly do anything in the course of practising as insurance brokers who comprise or impair, or are likely to compromise or impair, the good repute of insurance brokers or the insurance broking profession. d) Statements made by or on behalf of insurance brokers when advertising shall not be misleading or extravagant. f) Insurance brokers shall organise and control the internal affairs of their insurance broking business in a responsible manner, and where staff are employed ensure that they are compete, suitable, and under adequate day to day supervision by a registered insurance broker[112]". The Code of Conduct also sets out the principles respecting the conduct of brokers with regard to their relationship with its self-regulatory body[113], and their compliance with any statements

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[110] Section 5 of Insurance Brokers (Registration) Act 1977 (1977 c 46), *id.* at 899. With respect to the new regulatory regime, GISC in June 2000 issued the Commercial Code regarding the reinsurance intermediaries. According to the Section D-the Commercial Code of the GISC Rules, a Member of GISC should: "1.1 act with due skill, care and diligence; 1.2 observe high standards of integrity and deal openly and fairly with their commercial customers; 1.3 seek from Commercial Customers such information about their circumstances and objectives as might reasonably be expected to be relevant in enabling the Member to fulfill their responsibilities to them; 1.4 take reasonable steps to give Commercial Customers sufficient information in a comprehensible and timely way to enable them to make balanced and informed decisions about their insurance; 1.5 take appropriate steps to safeguard information, money and property held or handled on behalf of Commercial Customers; 1.6 conduct their business and organise their affairs in a prudent manner; 1.7 seek to avoid conflicts of interest, but where a conflict is unavoidable or does arise, manage it in such a way as to avoid prejudice to any party. Members will not unfairly put their own interests above their duty to any Commercial Customer for whom they act; and 1.8 handle complaints fairly and promptly." General Insurance Standard Council, General Insurance Standards Council Rules, <www.gisc.co.uk> (last visited: 05/06/2002).

[111] Insurance Brokers Registration Council (Code of Conduct) Approval Order 1994, SI 1994/2569, in JOHN LOWRY & PHILP RAWLINGS, INSURANCE LAW: DOCTRINES AND PRINCIPLES 338 (HART, 1999).

[112] Regulation 2 (2) A-H, in Insurance Brokers Registration Council (Code of Conduct) Approval Order 1994, SI 1994/2569, *supra* note 47, at 1512-1513.
See also id. at 338-339.

[113] It states that "E. Insurance brokers shall conduct their relationship with the Council, their

of principle issued under Section 47 A of the Financial Services Act 1986[114].

3. Requirements for carrying on business and professional indemnity cover

In addition to the Code of Conduct governing the activities of insurance brokers, brokers in the UK are required to ensure their solvency margin. The brokers are required to maintain a certain amount of working capital and the amount at which the value of assets of their businesses exceed the amount of the liabilities of their businesses[115]. The specified amount was prescribed in the Insurance Brokers Registration Council (Accounts and Business Requirements) Rules, Approval Order 1979(SI 1979/489)[116].

Furthermore, the broker may be liable for a breach of duty or incur legal liability arising otherwise from the broking business. As a result, the Council requires that practising insurance brokers and enrolled corporate bodies carry on and maintain the professional indemnity insurance against losses arising from claims stated in the Insurance Broker Registration Council (Indemnity Insurance and Grant Scheme) Rules Approval Order (SI 1987/1596)[117].

4. Regulatory reform in the United Kingdom

After the establishment of Financial Services Authority in 1997 and the enactment of the Financial Services and Markets Act in 2000, the Brokers (Registration) Act 1977, the Insurance Companies Act 1982 and the Financial Services Act 1986 were repealed.

In relation to the regulatory development in the United Kingdom, it is noteworthy that a proposal for the formation of a self-regulatory body-General Insurance Standards Council (GISC), sponsored by several professional

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professional body, with propriety; G. Insurance brokers should be familiar with, and in carrying on business should be mindful of guidance as to proper professional conduct contained in any Practice Notes issued or endorsed by the Council." Regulation 2 (2) E and G, Insurance Brokers Registration Council (Code of Conduct) Approval Order 1994, (SI 1994/2569), *supra* note 47, at 1511-1512.

[114] Regulation 2 (2) H, Insurance Brokers Registration Council (Code of Conduct) Approval Order 1994, (SI 1994/2569), *id*, at 1512.

[115] Section 11 of Insurance Brokers (Registration) Act 1977 (1977 c 46), *id.* at 902-903.

[116] *See* Insurance Brokers Registration Council (Accounts and Business Requirements) Rules, Approval Order 1979(SI 1979/489) Part II, 3., *id.* at 1483.

[117] *See* The Insurance Broker Registration Council (Indemnity Insurance and Grant Scheme) Rules Approval Order (SI 1987/1596), part II, 3., *id.* at 1501-1502.

organisations[118], was launched in 1998. The objective of this organisation is to build up an effective self-regulatory body to establish professional standards and competence[119] for those it regulates and the customers are protected[120].

In order to maintain the independence of the GISC, it will not "discriminate against or favour insurers as distinct from intermediaries, and is determined that the momentum in establishing the GISC as a creditable organisation must be maintained[121]". Additionally, the regulations or other codes of conduct issued by GISC will base on a consultation process[122] and will be a reflection of good business practice[123].

The Code of Practice, which was developed by the working groups in the Board of the GISC, is a combination of the existing ABI and IBRC codes. To ensure the financial solvency of intermediaries, the Code of Practice developed the following requirements: a) to keep insurance monies separate from other assets of the business; b) to maintain professional indemnity insurance; and c) to maintain a minimum solvency margin[124].

It was followed by that the establishment of the GISC and the General Insurance Standards Council Rules in June 2000[125]. Pursuit to GISC Rules, the regulatory subject-matter of the GISC is member's general insurance activities, which

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[118] These organisations are Association of British Insurers, the Association of Insurance Intermediaries and Brokers, the British Insurance and Investment Brokers Association, the International Underwriters Association/London Insurance and Reinsurance Market Association, Lloyd's and the Lloyd's Insurance Brokers Committee. *See* T. HENRY ELLIS & JAMES A. WILTSHIRE, *supra* note 89, at D1.1A-01 (Issue 65, August 2000). The GISC was officially launched on 3 July 2000. "In an announcement by the Treasury on 12 December 2001, Ruth Kelly MP(Economic Secretary to the Treasury) acknowledged GISC's hard work in raising industry standards and called for GISC to work closely with the Financial Services Authority (FSA) to ensure seamless transition from voluntary regulation by GISC to statutory regulation under the FSA, likely to be during 2004." General Insurance Standard Council, *New Watchdog for General Insurance Industry*, available at <http://www.gisc.co.uk/Home/> (last visited 20 April 2002).

[119] "to establish, promote, monitor, and enforce high standards of integrity, financial soundness, fair dealing and competence for those it regulates." *See id.* at D1.1A-01.

[120] With respect to the protection of customers, the purpose of this proposal is "to ensure that as far as possible policies that are proposed are suitable to the needs and resources of customers and that customers are informed about the products they are buying and their place; and to ensure that adequate systems are in place for dealing with customer complaints and ensuring that redress is available." *See id.*

[121] *See id.* at D1.1A-06.

[122] In order to ensure the independence of this self-regulator body, the consultation process will not only comprise members of the GISC, but also trade associations and consumer groups. *See id.* at D1.1A-17.

[123] *See id.* at D1.1A-06.

[124] *See id.* at D1.1A-17.

[125] General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *supra*

also includes relevant reinsurance and retrocession[126]. The GISC set out several financial requirements to apply to all intermediaries in Section G1- Financial Requirements.

These financial requirements are divided into three main subsections: Insurance Money Segregation, Professional Indemnity Insurance and Solvency Requirement[127].

a. Insurance money segregation

In order to keep all monies, including premiums and claims, from other assets of business, the intermediaries shall "maintain one or more separate Insurance Bank Accounts with an Approved Bank and containing in its title the name of the Member, together with the designation Insurance Bank Account (or IBA)"[128]. Insurance Intermediaries only use an IBA for specified purposes provided in these rules[129]. In addition, intermediaries can obtain a loan or overdraft for any purpose related to an IBA only if

a) the loan or overdraft is "used for the payment to Customers or Insurers of Monies due under General Insurance Activity[130] transactions;

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note 47, at 1661-1720.

126 Section A-General, Scope and Objective 1., General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1661-1720.

127 Section G1-Financial Requirements-Practical Requirement 1-32, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1692-1697.

128 Section G1-Financial Requirements-Practical Requirement 1.2, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1692-1697.

129 Insurance Intermediaries can "only use an Insurance Bank Account for the following purposes: "1.5.1 the receipt of Insurance Monies; 1.5.2 the receipt of such monies as may be required to be paid into the Insurance Bank Account to ensure compliance by the Member with any conditions or requirements prescribed by GISC; 1.5.3 the payment to Customers or to Insurers of monies due under General Insurance Activity transactions; 1.5.4 the payment of all monies payable by the Member in respect of the acquisition of or otherwise in connection with Approved Assets; 1.5.5 the withdrawal of brokerage and other general insurance activity-related income either in cash or by way of transfer to an account in the name of the Intermediary which is not an Insurance Bank Account (but so that no amount received by an Intermediary by way of Net Retained Brokerage and other General Insurance Activity-related income may be withdraw from the Insurance Bank Account before the time at which, in accordance with the accounting the accounting policies adopted by the Intermediary, that amount may be brought into account as income of the Intermediary); 1.5.6 the withdraw of monies paid into the Insurance Bank Account in error; and 1.5.7 the withdraw of any monies credited to the Insurance Bank Account in excess of those required by any conditions and requirements prescribed by GISC." Section G1-Financial Requirements-Practical Requirement 1.5, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1692.

130 "General Insurance Activities means Regulated Activities carried on from a permanent place of business within the United Kingdom in connection with one or more General Insurance Products (unless GISC agrees to restrict the application of the Rules to a specified category to a Member's General Insurance Activities)". *See* Section B-Definition, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1665.

b) does not give rise to a breach of the requirements of that any amount held in the IBA or other Approved Assets, together with any amount due and recoverable from insurance debtors, is equal to ,or greater than the amount due to insurance creditors[131]; or

c) is of a temporary nature and is repaid as soon as reasonable practicable[132]".

In relation to holding insurance monies, intermediaries are to hold their "Insurance Monies" in an "Insurance Bank Account" with one or more "Approved Banks", or in "Approved Assets" and shall follow the requirements specified in the section G1, 3-8. Furthermore, the GISC require that the intermediaries to make appropriate investment arrangements and maintain a suitable level of liquidity to ensure their financial soundness[133]. The requirement to segregate insurance monies does not apply if the following conditions are met:

"the intermediary is regulated by a recognised regulatory or professional body approved by GISC; the intermediary has sought and obtained confirmation from

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[131] Section G1-Financial Requirements-Practical Requirement 1.6, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1692.

[132] Section G1-Financial Requirements-Practical Requirement 2.1-2.3, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1693.

[133] As to the definition of Insurance Monies, it has been provided in the GISC Rules that "Insurance Monies means the following individual items or balances representing the same arising from General Insurance Activities: 1. premiums, additional premiums and return premiums of all kinds; 2. claims and other monies due under the contracts of insurance; 3. Refunds and salvages; 4. fees, charges, taxes and similar fiscal levies relating to contracts of insurance; 5. all form of reserves under contracts of insurance and any adjustment to them; and 6. discounts, commissions and brokerage." In addition, the Insurance Bank Account means "a bank account designated as an Insurance Bank Account for holding Insurance Monies in accordance with the Financial Requirements. This must be an account offered by an Approval Banks and may be an ordinary, current, savings, investment, call, notice, treasury, money market, or deposit account." *See* General Insurance Standard Council, General Insurance Standards Council Rules, <www.gisc.co.uk> (last visited: 05/06/2002). In relation to the investment requirements, the Membership Practice Requirement of GISC Rules provides that: "10. Intermediaries' investment arrangements shall include: 10.1. a suitable diversification policy and strategy; 10.2. a suitable liquidity strategy to ensure the timely meeting of financial obligation relating to Insurance Monies; 10.3 a suitable credit risk policy and strategy; 1.4 an overall investment policy and strategy which has been approved by the Intermediary's board of directors or equivalent body; 10.5 appropriate and prudent custody arrangements; 10.6 the prudent management of foreign exchange risks; 10.7 the proper recording, monitoring and control of investments; 10.8 the proper supervision of internal and external investment managers, if any; and 10.9 a review of investment performance at least every 6 months by the Intermediary's board of directors or equivalent body.
11. Where Insurance Monies are held in Approval Assets whose rating drops below the minimum stipulated within the definitions, that investment or asset will cease to be an Approved Assets and the Intermediary must dispose of the investment or asset as soon as possible and no later than within 20 business day of the rating change.
12. Where any Approved Bank, Approved Asset or Approved Bank, Approved Asset or Approved Investment has more than one rating, the lowest of the ratings will apply.
13. The use of derivatives is not permitted except for the prudent management of currency exchange risk." Section G1-Financial Requirements-Practical Requirement 9-13, General Insurance Standard

GISC that their General Insurance Activities are secondary to the main business activity of the intermediary; the Intermediary is a Single-Tied Agent or a Multi-Tied Agent; their General Insurance Activities are covered by agency agreements which ensure the maintenance of reinsurance cover; the intermediary's annual Net Retained Brokerage is less than £5,000 and premiums handled are less than £ 50,000 per annum[134]."

b. Professional indemnity insurance

The GISC established several requirements respecting intermediaries taking out and maintaining professional indemnity cover. The professional indemnity insurance should indemnify losses arising in the course of its "General Insurance Activities" and those of its "Appointed Agents" and "Appointed Sub-Agents"[135]. The professional indemnity insurance should not contain any term to the effect that payment of claims indemnifies the insured first[136]. The amount of indemnity is to be at least £1million or 3 times the annual "Net Retained Brokerage"[137] and the minimum level of indemnity must apply to any one claim and in the aggregate[138].

c. Solvency margin

The scope to solvency requirement applies to those who are "required to segregate insurance monies and may apply where the uninsured excess under a professional indemnity insurance exceeds the permitted limit"[139]. Intermediaries whose practice is to withdraw revenue on a "received basis" must have sufficient assets to meet their liabilities[140] whereas those whose practice is based on a "earned basis" must maintain

Council, General Insurance Standards Council Rules, June 2000, *id.* at 1693.

[134] Section G1-Financial Requirements-Practical Requirement 18.1-18.5, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1694-1695.

[135] Section G1-Financial Requirements-Practical Requirement 19.1.1-19.1.6, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1695.

[136] Section G1-Financial Requirements-Practical Requirement 19.2, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1695.

[137] Section G1-Financial Requirements-Practical Requirement 19.5, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1695.

[138] Section G1-Financial Requirements-Practical Requirement 19.6, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1695.

[139] Section G1-Financial Requirements-Practical Requirement 23, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *id.* at 1696.

[140] "Received basis" is "the practice of withdrawing Revenue due in respect of a particular sum only after the payment has been received into the Insurance Bank Account or is due under a formal credit arrangement (that includes payments due from agents within a formally agreed period not exceeding 30 days). Section G1-Financial Requirements-Practical Requirement 24, General Insurance Standard Council, General Insurance Standards Council Rules, <www.gisc.co.uk> (last visited: 05/06/2002).

net assets, as determined by Generally Accepted Accountancy Principles (GAAP)[141].

D. Summary Observations: a Comparative Analysis on the Leading Regulatory Models

As discussed above, regulation of reinsurance intermediaries is concerned with, and should take into account, the complexities of market practices and the general law of agency. Also, as discussed above, while the conduct of reinsurance intermediary may endanger the solvency of the reinsurers and the primary insurers, it is essential to develop a viable regulation not only to maintain the stability of insurance market but also to promote fair competition.

In looking to the developed models (discussed above) governing reinsurance intermediaries, several significant features are worth noting in considering an appropriate regulatory model approach for the emerging markets.

1. The scope of regulation and fitness and propriety of management

With regard to entry requirement, these leading regulatory models adopt a licensing or registration procedure with intermediaries being required to obtain authorisation to carry on their insurance business. However, differences exist in the scope of their intermediary regulation. In the United States, reinsurance intermediaries are catergorised into reinsurance brokers and reinsurance managers. In the UK, the self-regulatory body-IBRC is only responsible for registering all those conducting the business of insurance brokers. In other words, the statutory instruments issued by the IBRC can only be applied to those who carry on broking business and use the description of the insurance brokers ("reinsurance brokers"). As a result of the limited scope of this regulation, it had been criticised that some people who may carry on broking business used alternative names such as "consultants" or "intermediaries"[142]. Due to the lack of statutory definition of broking provided in the Insurance Brokers (Registration) Act 1977, this act "does not prevent unregistered persons carrying on the activity of broking"[143]. It should be noted, however, that this Act restricts the use of the titles and descriptions. After the enactment of the Financial Services and Markets Act 2000 which still encourages the introduction of a self-regulatory scheme

[141] Earned Basis means that intermediary withdraws "revenue from an IBA other than deducting revenue on a Received Basis." *Id.*
[142] *See* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 1, at 333.
[143] *See id.* at 404.

for the general insurance intermediaries, the General Insurance Standards Council (GISC) are established. The GISC rules not only now govern the reinsurance brokers but also extend to regulate other reinsurance intermediaries.

As mentioned above, the European Union steps forward to extend the scope of regulation and has published a proposal for the directive addressing insurance mediation that would include the reinsurance mediation and reinsurance intermediaries. This proposal provided that reinsurance mediation means the activities "of introducing, giving information, proposing or carrying out work preparatory to the conclusion of contracts of insurance, or in assisting in the administration and performance of such contracts, particularly in the event of a claim"[144]. However, it has not proposed the specific requirements for different intermediary whereas the GISC has issued two codes of conduct, one for dealing with private consumers and the other covering commercial customers.

In general, the regulatory development on these developed countries intends to extend the scope of regulation of intermediary. While the reinsurance intermediary generally deals with professional enterprises, it is suggested that differences between the reinsurance intermediary and insurance intermediary should be drawn and the flexibility of the regulation should be enhanced to prevent the distortion of reinsurance business.

As a result of the importance of fitness and propriety of management, the licensing or registration process should contain relevant discretionary criteria in considering application for registration or establishment of a reinsurance intermediary. The discretionary criteria should take into account the competence, practical experience and suitability of the applicant as a reinsurance intermediary.

Learning from these models, the licensing or registration authority should be able to assess the fitness and propriety of management. The relevant discretionary generally relates to the competence of the key personnel. However, in the case of Pritchard, the principal owner of the reinsurance intermediary-Pritchard & Baird withdrew large amounts of money estimated to be as high as $ 40 million from the firm and this consequently resulted in the firm's bankruptcy. With this in mind, it is suggested that the scope of the qualification check should be extended to major

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144 Proposal for a Directive of the European Parliament and of the Council on Insurance Mediation

shareholders.Further, special emphasis should be given to the key personnel, and major shareholders' past record, in particular with regard to any illegal, fraudulent or dishonest activities they were involved in.

2. Market conduct control

In terms of market conduct control regarding reinsurance intermediary, the NAIC and the UK adopted different approaches. Under the UK regulatory regime, the regulation relating to the market conduct was provided in a IBRC "Code of Conduct" that sets out several fundamental principles to regulate the intermediary directly. In other words, the regulation adopted by the UK required the intermediary to exercise "reasonable skill and care" in the placement of the reinsurance cover or the assessment of risk. However, this Code of Conduct does not intend to deal with the legal duties and contractual relationship between intermediary and his principal. Instead, the law of agency, customary practices and the decision of courts govern relevant legal duties and arrangements in this regard.

In contrast, the approach adopted by the NAIC model is to require the contract between reinsurance intermediary and his principal to contain specific provisions addressing legal duties and relevant rights. This model extends the protection of the ceding insurers and reinsurers by the means of compulsory provisions in the relevant arrangements. Furthermore, it not only regulate the conduct of reinsurance intermediary but also require the principals of reinsurance intermediaries to exercise "reasonable care" in delegating their authority.

It seems that the approach adopted by the NAIC provides a comprehensive regulatory control on the conduct of intermediary and his principal. It should be noted, however, that such an approach might result in a legal challenge that this regulation interferes in the private contractual relationship between the reinsurance intermediaries and their principals. Consequently, this may impede the flexibility of reinsurance transactions and increase the transaction costs. Whether it is appropriate to adopt such an approach should depend on the specific legal environments and market practices in a particular country.

In addition to the implementation of market conduct control as to the reinsurance intermediaries, several important aspects regarding the conduct of

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(COM (2000) 511 final) (200/213/EC), art. 2 (4), OJ C29E/245.

reinsurance intermediaries are considered in these models, and, differences exist between these developed approaches. In the NAIC model[145], the intermediary arrangement regarding the scope of authority is required to contain provisions concerning the insurer's right to terminate, the intermediary's duty to maintain a complete record of related documents, and the security of insurance monies arising from premiums and claims. However, the reinsurance intermediary's conduct relating to exercising "reasonable care and skill" has not been considered in these provisions. In contrast, the IBRC Code of Conduct[146] (as amended under the GISC Rules) describes the conduct of the brokers more specifically and sets out eight fundamental principles. In addition to these fundamental principles, the Code of Conduct further provides specific examples of the application of these principles. In relation to the relationship between brokers and consumers, the Code of Conduct requires insurance brokers to exercise all the reasonable care and skill when they conduct their broking business.

In the field of reinsurance intermediary, the main concern for regulators and insurers is whether reinsurance intermediaries will exercise "reasonable care" in the placement of reinsurance cover or assessment of insurance risks. However, these developed models do not provide specific provisions concerning what constitutes "reasonable care and skill". As mentioned above[147], whether a reinsurance intermediary meets a reasonable intermediary's test generally depends on the customary industry standard. Due to the lack of relevant guidelines or a code of conduct, this issue may lead to the legal disputes. In the case of selection of reinsurers, it has been observed that a reasonable broker should assess a reinsurer's financial rating, corporate structure, Insurance Regulatory Information System ratio, annual report, and reputation[148]. As a result of legal disputes arising from a reinsurance intermediary's duty of care, it is suggested that the relevant regulation or a code of conduct issued by a self-regulatory body should provide specific guidelines and possible non-exhaustive examples for the reinsurance intermediaries. Such guidelines may not only be used to reduce legal uncertainty but also may be used as a

[145] *See generally* Reinsurance: Reinsurance Intermediary Model Act, *supra* note 47.
[146] *See generally* Code of Conduct, Insurance Brokers Registration Council (Code of Conduct) Approval Order 1994, (SI 1994/2569).
[147] *See* Chapter 3 I A.
[148] *See Cherokee Ins. Co. v. E.W. Blanch Co.*, 66 F. 3d 117 (6th Cir. 1995), cert. Denied, 116 S.Ct. 1545 (1996).

reflection of customary practices for the courts in deciding relevant disputes.

3. Financial requirement: segregation of insurance monies, solvency and professional indemnity insurance

One of the main regulatory issues regarding reinsurance intermediary is whether the intermediary will maintain its financial solvency and will exercise reasonable care in the maintenance of insurance monies. In addition to solvency margin and accounting requirements, professional indemnity insurance generally is required to cover legal liabilities arising from the relevant transactions.

The developed models, discussed above, generally require the reinsurers to separate the insurance monies from the general account of the reinsurers. In the GISC model, an Insurance Business Account is formed to hold the monies receiving from the premiums and claims[149]. The use of an IBA has been restricted in that it can be used only in connection with general insurance business activities. In the NAIC Model Act, all funds collected for the (re)insurer's account should be held by the reinsurance intermediary in a fiduciary capacity in a qualified financial institutions. Although these two models require the insurance monies from premiums and claims should be held in a segregated account, it does not mean that such an account is deemed as a trust on the behalf of the reinsurers or insurers, particularly under the UK approach. In order to enhance the protection of customers, the proposal made by the EU Commission in 2000[150] suggested that "the customer's monies shall be transferred via strictly segregated client accounts and that these accounts shall not be used to reimburse other creditors in the event of the bankruptcy.[151]" Furthermore, this proposal adopted the similar approach as under the Intermediary Clause approach in the US. This proposal stated that

"-member state may lay down the provisions by law "whereby monies paid by the customer to the intermediary are treated as having been paid to the undertaking, whereas monies paid by the undertaking to the intermediary are not treated as having been paid to the customer[152]".

[149] *See* GISC Rules, Section G: Membership Practice Requirements, Practice Requirement G1-Financial Requirements, *supra* note 47, at 1692.
[150] *See generally* Proposal for a Directive of the European Parliament and the Council on Insurance Mediation, (Com (2000) 511 final), (2000/213/EEC).
[151] Proposal for a Directive of the European Parliament and the Council on Insurance Mediation, art. 4 (4) (C)(Com (2000) 511 final), (2000/213/EEC).
[152] Proposal for a Directive of the European Parliament and the Council on Insurance Mediation, art. 4

In the case of reinsurance brokers, the reinsurance premiums paid by the ceding insurers is treated as having been paid to the reinsurers, whereas claims paid by the reinsurers to the intermediary are not treated as having been paid to the ceding insurers. In other words, the reinsurers will bear the ultimate loss from the credit risk of the reinsurance brokers.

In comparison, these developed models tend to protect the ceding insurers and consequently result in increased burdens on the reinsurers. From the viewpoint of protection of ceding insurers, it seems that a legal provision requirement that the reinsurers to bear the ultimate loss from credit risk of the reinsurance intermediaries is the most efficient approach in promoting the security of insurance monies and for protecting the interests of the ceding insurers. It should be noted, however, that the insolvency of reinsurance intermediary may affect the solvency of reinsurers and hence the financial condition of the primary insurers. In addition, the ceding insurers may act as a reinsurer to accept reinsurance business. Unlike other insurance customers, the financial burdens imposed on these insurers and reinsurers may have an adverse effect on the solvency of insurers. As a result, it is suggested that the monies received from the premiums and claims should be regulated *prudentially.* Therefore, the regulation should not only segregate the insurance monies from the general account of the reinsurance intermediaries but also should lay down provisions regarding limitations on the holding and investing of these insurance monies.

As a result of the importance of the financial solvency of the reinsurance intermediaries, the GISC rules specify solvency requirements. These requirements do not, however, specify the method to calculate the solvency margin. Alternatively, the intermediary can choose a practical basis either on an "earned basis" or "received basis". In addition to the solvency requirement, the GISC Rules require intermediaries to make appropriate investment arrangements and to maintain a suitable level of liquidity to ensure their financial obligations relating to these insurance funds. However, these developed models do not provide particular investment regulation for the general account of the reinsurance intermediaries. Although the GISC rules regulate the investment of "approved assets" in connection with the insurance business account, potential investment risk still exists if the appropriate investment regulation is not applied to the general assets and investments of intermediaries.

(4) (a) (Com (2000) 511 final), (2000/213/EEC).

In the event of legal liability arising from professional negligence, the proposal issued by the EU Commission and the UK GISC rules require reinsurance intermediary to hold professional indemnity insurance or some other comparable guarantee[153]. In order to prevent the insolvency of the intermediaries, the professional indemnity insurance is essential to safeguard the financial stability of reinsurance intermediary and their principals, including the insurers and the reinsurers. No matter what other different types of "guarantee" the reinsurance intermediary may provide, it is appropriate to require a certain minimum amount of the guarantee or professional indemnity insurance against the legal liabilities arising from professional negligence.

VI. Concluding Observation: Implication of Appropriate Reinsurance Intermediary Regulation in Emerging Markets

In emerging markets, the insurers often rely on reinsurance intermediaries to cede insurance risk or to accept reinsurance business. Furthermore, the transactions between the insurers and reinsurance intermediaries are generally cross-border. Under these circumstances, the regulation of the reinsurance intermediaries becomes complicated when it comes to the implementation stage. In addition to this difficulty, it should be noted that the enactment of the overly strict regulation might impede the freedom of reinsurance transactions and the diversification of insurance risks.

Learning from the developed regulatory models in the US, EU and the UK, several fundamental aspects should be considered when an emerging country seeks regulatory reform in this area. To prevent inappropriate transactions costs and to develop a viable and comprehensive regulatory regime relating to reinsurance intermediary, the development of these regulations should take into account the particular market characteristics and existing legal system.

First of all, a suitable entry requirement should be developed to regulate the reinsurance intermediaries who conduct business with domestic insurers. With regard to this entry requirement, a registration or licensure approval should be implemented. It is suggested that the entry requirements should include the following aspects:

[153] Proposal for a Directive of the European Parliament and of the Council on Insurance Mediation, art. 4 (3) (COM (2000) 511 final) (200/213/EC), *supra* note 47, at 2412. Section G1-Financial Requirements-Practical Requirement 19.1.1-19.1.6, General Insurance Standard Council, General Insurance Standards Council Rules, June 2000, *supra* note 47, at 1695.

"fitness and propriety" of management (consisting of the competence, practical experience and suitability of key staff including the major shareholders); the adequacy of capital and liquidity of assets to meet any liability from operation of insurance business; and the holding of a certain amount of professional indemnity insurance or other comparable guarantee against any legal liability arising from professional negligence in connection with the insurance business activities. While some emerging markets may already have a regulatory regime relating to insurance intermediary, it is appropriate to amend any existing regulations if needed so that they can be applied to the reinsurance intermediaries. Notwithstanding the need for a comprehensive regulatory framework and set regulatory control, it is suggested that the "flexibility" of regulation should be maintained to prevent any distortion of freedom to conduct reinsurance business.

Secondly, the market conduct of reinsurance intermediary should be considered as the essential part of a viable regulatory regime. This regulation should ensure the reinsurance intermediaries to exercise "reasonable care and skill" in carrying on their insurance business. As mentioned above, the approach adopted by the NAIC might interfere unduly with the customary agency of law and thus may impede the freedom of private contracts. The UK approach, which lays down fundamental principles and states numerous illustrative examples, seems a more appropriate for emerging market countries. In any event, the reinsurance intermediaries should be subject to criteria to ensure that they meet high standards of competence and integrity. These criteria would ensure that the reinsurance intermediaries exercise "reasonable care and skill" in carrying on their insurance business activities and the monies received from premiums and claims would be held prudentially. In addition, these criteria should address issues such as the avoidance of conflict of interests arising from intermediaries being "dual agents", the avoidance of legal disputes among the scope of authority relating to sub-agency, "timely and best execution" of transactions, the right of the (re)insurers to terminate the arrangements, and the duty of reinsurance intermediary to maintain the relevant documentation.

Thirdly, the insurance monies held by the reinsurance intermediary should be maintained in a segregated account, which should be separated from the general assets of the reinsurance intermediaries. The reinsurance intermediaries should be subject to minimum standards to ensure that the insurance monies will be held and invested in the relevant insurance business. It is crucial to ensure that in the event of bankruptcy of an intermediary these accounts shall not be used to reimburse other creditors.

Fourthly, it is a common practice that insurers in emerging markets accept or assume reinsurance business by means of pool and fronting arrangements. On the other hand, the insurers might transfer their insurance risk to other unauthorised reinsurers through these fronting arrangements. As a result of legal disputes that may endanger the solvency of the insurers and the fronting insurers, the regulation should be able to provide a mechanism to monitor these arrangements. Yet, it needs to be kept in mind that undue restrictions on these arrangements increase transaction costs, and may have a significant adverse impact on the ability of the reinsurers to accept insurance risk internationally. It, therefore, would be appropriate to require insurance undertakings to disclose the relevant information regarding their risk retention and fronting arrangements.

Chapter Four

Alternative Risk Transfer and Reinsurance Regulation: Regulatory Issues arising from Financial Reinsurance and Securitisation of Insurance Risk

In addition to the traditional reinsurance vehicle, there are several alternative methods to transfer insurers' risk arising from operating and underwriting with respect to the insurance business and investments. Such alternative risk-financing techniques[1] typically involve the funding of underwriting risk from life insurance or non-life insurance through the capital market and investors[2]. Although the underlying risks (underwriting risk or other financial risk) are not extraordinary, nor are the subject financial structures and instruments necessarily unique (securitisation structures and derivative mechanism have existed for the past several decades.), the application of such structures and instruments to existing insurance risks are truly extraordinary and unique[3].

While the development of these risk transfer instruments has increased significantly in recent years, this also has raised considerable concerns to regulators, accountants, investors and insurers. In general, alternative risk transfer structures for insurers can be divided into four categories as follows[4]:

A.Reinsurance

As mentioned in the previous chapters, the main function of reinsurance is to transfer the insurer's risk to the reinsurers. Traditional reinsurance can transfer all the components of an insurer's underlying risk including underwriting risk and timing risk. Since the 1960s, financial reinsurance for transferring the "timing risk" and other "financial risks" arising from investment, currency exchange and interest rate fluctuations, has been developed for developing obtain greater capacity, and smoother management of insurer's risk in the Lloyd's market[5]. Regulators have struggled to

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[1] *See generally* Society of Chartered Property and Casualty Underwriters, THE ALTERNATIVE MARKET (International Risk Management Institute, 1994).

[2] *See* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *Legal and Regulatory Issues Affecting Insurance Derivatives and Securitization*, in SECURITIZED INSURANCE RISK STRATEGIC OPPORTUNITIES FOR INSURERS AND INVESTORS 77, 77 (Michael Himick ed., Glenlake, Chicago 1998).

[3] *See id.* at 77.

[4] *Id.* at 80.

[5] *See* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, REINSURANCE 730 (4th ed., 2000).

develop a suitable regulatory regime and as a result after have ended up considering transactions on an individual basis, *ad hoc,* by looking either at the "economic substance" of the product, or at its form[6].

B. Securitisation of Insurance Risk

Securitisation of insurance risks provides additional capacity for the insurance and reinsurance markets by tapping into capital markets through insurance-linked securities. From the viewpoint of investors, insurance-linked securities also offer the advantage of diversifying their portfolios without bearing "interest rate risk"[7]. In general, a "special purpose vehicle" (SPV) is created to provide reinsurance coverage for the ceding insurers and to issue the insurance-linked securities to investors. A trust is also created for collecting funds from investors while ceding insurers pay premiums to the SPV in exchange for reinsurance coverage. The ultimate return can be based on the actual loss of the ceding insurer, the performance of the related index, the occurrence or nonoccurrence of a specific event, or the physical parameters of a natural hazard[8]. Insurance-linked securities can be designed both on a "principal-at-risk" or on a "principal-protected basis", with variable coupons/or extension of maturity providing the underlying risk fundings[9].

C. Insurance Derivatives

Insurance derivatives involve the transfer of non-life insurance risk through the issuance of one or more derivative instruments, such as an option through the Chicago Board of Trade (CBOT) and Bermuda Commodities Exchange (BOCE) and swap activity at Catastrophe Risk Exchange (CATEX)[10]. Under such a transaction, an insurer or reinsurer can invest its underwriting risk in the future depending upon the performance of that risk as a hedge instrument. In December 1992, CBOT opened the

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See also REINSURANCE PRACTICE AND THE LAW, LLP, at 14-5 (Colin Croly & Michael Mendelowitz eds., Service Issue No. 14-1, March 2000).

6 *See* Omar Hameed, Alternative Risk Transfer-Legal and Regulatory Issues, 39 BLG INSURANCE LAW QUARTERLY 8, 8 (Barlow Lyde & Gilbert, London, Autumn 1999).

7 Bertil Lundqvist, *Catastrophe Bonds as a Method of Securitizing Insurance Risk*, in New Developments in Securitization 1999, at 801 (Commercial Law and Practice Course Handbook Series PLI Order No. A0-0033, Practising Law Institute, December 1999).

8 *See* Eduardo Canabarro, Markus Finkemeier, Richard R. Anderson & Fouad Bendimerad, *Analyzing Insurance-linked Securities*, FINANCING RISK & REINSURANCE September 1999, 3, at 5 (International Risk Management Institute, 1999).

9 *See* Eduardo Canabarro, Markus Finkemeier, Richard R. Anderson & Fouad Bendimerad, *id.* at 5. *See also* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *supra* note 2, at 81.

10 *See generally* SECURITIZED INSURANCE RISK STRATEGIC OPPORTUNITIES FOR

first-ever exchange-traded insurance derivatives market to "build a new bridge between the insurance and capital markets upon which insurers and reinsurers could transfer catastrophe property risk to a large pool of private investor capital"[11].

D. Liquidity and Contingent Capital Facilities

Unlike other risk transfer mechanisms, liquidity and contingent capital facilities typically involve a predetermined obligation to provide financial support to the enterprises, the ceding insurer and the reinsurers upon either the occurrence of a specific "trigger", or at the election of the covered party[12]. The main function of liquidity facilities is to provide funds or capital for the payment of loss during the initial periods following a specific event such as a catastrophe. Contingent capital facilities "provide the subject entity with the right to put its equity to the contingent investors"[13].

Most of the financing risk instruments mentioned above are designed to transfer insurance risk from one party to another. *Finite risk reinsurance* (financial reinsurance) and *insurance securitisation* are based on the reinsurance contract. As the main purpose of this volume is to discuss the regulation of reinsurance, this chapter will focus on those transactions, formed as reinsurance contracts, including financial reinsurance and the securitisation of risk.

With regard to finite risk reinsurance, the types of instruments will be introduced and described, along with their characteristics. This is followed by a discussion of relevant regulatory issues arising from such reinsurance contracts. Several leading regulatory models, including the United States and the United Kingdom, will then be analyzed. Drawing on these developed country regulatory models, suggestions based on this comparative analysis will be provided as to possible emerging market approaches.

The second part of this chapter will discuss regulatory issues relating to securitisation of insurance risk. First, the general structure of securitisation of risk will be identified. Subsections II and III follow with an explanation of the motivations for

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INSURERS AND INVESTORS (Michael Himick ed., Glenlake, Chicago 1998).

[11] *See* Sylvie Bouriaux, Michael Himick, *Exchange-Traded Insurance Derivatives: Catastrophe Options and Swap*, SECURITIZED INSURANCE RISK STRATEGIC OPPORTUNITIES FOR INSURERS AND INVESTORS 23, at 24 (Michael Himick ed., Glenlake, Chicago 1998).

[12] Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *supra* note 2, at 81-82.

[13] *Id.* at 82.

insurance-linked securities as taken into account by policyholders, investors and insurers, focusing on characteristics that facilitate and hinder transactions. Furthermore, the regulatory issues relating to securitisation of risk will be discussed. These relevant issues are then categorised into three parts including the issuance of insurance-linked securities, the corporate structure of special purpose reinsurers and reinsurance regulation relating to these transactions. This will be followed by an analysis of certain developed regulatory models and by selective conclusions.

I. Finite Risk Reinsurance and Reinsurance Regulation

From the viewpoint of risk management, the principal risk for an insurer is the underwriting risk that the losses actually paid differ from the expected losses due to "changes in the underlying condition (risk of change), to random events (risk of random fluctuations) or erroneous calculations (risk of error)"[14]. In other words, underwriting risk arises from a mismatch between the expected losses and economic damage from a defined peril, which may range from smoke damage to hurricane wind, from slander to malpractice. Apart from underwriting risk, all insurers are exposed to the adverse effects of timing risk[15], investment risk[16] and credit risk[17]. Insurance and reinsurance can either transfer all components of an underlying risk (underwriting risk and timing risk), or they often can address timing risk or other financial risk including investment risk and credit risk, with a less-than-complete transfer of subject underwriting risk. The latter form of reinsurance arrangement was traditionally known as "Financial Reinsurance" during the 1980s, whereas it is now commonly known as "Finite Risk Reinsurance[18]".

Since the 1960s, a variety of innovative reinsurance products have been

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[14] *See* Swiss Re, *Alternative Risk Transfer via Finite Risk Reinsurance: an Effective Contribution to the Stability of the Insurance Industry*, 5 SIGMA 1, at 11(1997).

[15] "Timing risks" result from erroneous expectations relating to the rapidity of "settlement risk". If the actual time of claim settlement is earlier than the planned one, it will reduce the investment earnings because interest-bearing capital in the form of technical provision is lost earlier than expected. *See* Swiss Re, *id.* at 11. *See also* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *supra* note 5, at 735.

[16] Investment and currency exchange risk mainly are divided into three part: investment risk, interests risk and currency exchange risk. The investment risk tends to be affected by the length of the delay between the receipt of premium and the payment of liability. *See* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *id.* at 735.

[17] For the ceding insurer, credit risk is the risk that the reinsurer will be unable to pay the amount due the ceding insurer because of financial insolvency or other difficulties. *See* DIANE WALLACE, RISK TRANSFER IN LIFE INSURANCE COMPANY REINSURANCE TRANSACTIONS 6 (Reinsurance Section of the Society of Actuaries, Schaumburg, August 1995).

developed to "enable individual's organisations and insurance companies to better manage financial risks[19]". As the use of these arrangements could especially optimize the balance sheet as well as contradict the "true and fair view" principle in some cases, these arrangements are gaining increasing the attention of supervisors and tax authorities. The initial function of reinsurance is to transfer the liability for potential future losses arising from actual insurance underwriting risks[20] along with the premium corresponding to such risks. Finite risk reinsurance, however, mainly transfers finite risk[21] that could affect the reality of future profits (*e.g.*, investment and interest profit) of insurance companies from future loss payments through a deterioration of an insurer's loss reserves. This controversial reinsurance contract plays an important focus in the issue of reinsurance and solvency regulations[22].

A. Types of Finite Risk Reinsurance and their Characteristics

Due to the complexity and diversity of finite risk reinsurance, it is difficult to summarise adequately their different types. Nevertheless, it has been observed that finite risk contracts can be divided into two main categories; namely *retrospective loss reinsurance*, which reinsures existing business, and *prospective loss reinsurance*, which reinsures future business[23].

1. Retrospective loss contracts

A retrospective loss reinsurance is a contract where under a reinsurer provides a ceding insurer with the coverage for liabilities incurred as a result of past events

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[18] *See* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *supra* note 2, at 80.

[19] *See* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *supra* note 5, at 730. *See also* REINSURANCE PRACTICE AND THE LAW, *supra* note 5, at 14-5 (Service Issue No. 14-1, March 2000).

[20] "Underwriting risk is against the resulting economic damage from a defined peril, which may range from smoke damage to hurricane wind, from slander to malpractice." ROSE PHIFER, REINSURANCE FUNDAMENTALS-TREATY AND FACULTATIVE 99 (1996).

[21] There are several types of finite risk. For example, investment return risk is the uncertainty as to the ultimate investment return that a reinsurer will earn, other than by reason of the timing risk, on net moneys accruing under a reinsurance contract. *See* The Institute of Chartered Accountants in English and Wales, Accounting for Non-Life Financial Reinsurance: A Discussion Paper, at 6(1992).

[22] For example, The Insurance Committee in OECD discusses major recent policy issues in solvency regulations which include financial reinsurance. *See* OECD, INSURANCE IN FINANCIAL, INVESTMENT, TAXATION AND COMPETITION, at 3, (12 April 1998) available at <http://www.oecd.org/search97cgi/s97_cgi>.

[23] *See* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *supra* note 5, at 740-750. *See also* Daniel S. Jones & Richard N. Glaser, *Finite Risk Reinsurance-A Year 2000 Solution*, FINANCING RISKS & REINSURANCE December 1998, 3, at 9-10(1998). P. T. O'NEILL, & J. W. WOLONIECKI, THE LAW OF REINSURANCE IN ENGLAND AND BERMUDA 313(1998).

covered under contracts[24]. In general, retrospective loss contracts are used for "long-tail" business (i.e., liabilities insurance in which the reinsured may obtain the effective benefit of discounting reserves to allow for the time value of money)[25].

a. Funded cover contract

At the end of the 1960s, many Lloyd's syndicates developed the initial form of financial reinsurance that was commonly called "rollovers". Under this arrangement, these Lloyd's syndicates received from the reinsurer the entire premium paid, together with interest at an agreed rate or that was earned through the investment of the reinsurer. When the syndicates produced an underwriting profit in good years, part of the profit would be paid as a reinsurance premium to the reinsurer. The premiums were "rolled over" from year-to-year together with interest or investment profit and then were put into a fund available for return to the syndicates whenever they wished[26]. It has been argued that such an arrangement can be deemed a genuine reinsurance contract, because there is no transfer of insurance risk to the reinsurer. As a result, the UK Inland Revenue investigated rollovers in the 1980s and Lloyd's reached an overall settlement with the Inland Revenue for a figure of around £40 million in 1985[27].

"Funded cover" contracts mainly provide reinsurance recoveries in the future for ceding insurance enterprises. The premium paid by the ceding enterprises was based simply on the present value of the agreed series of payments. The payment from the reinsurer is structured on a financial basis rather than on an indemnity basis. As a result, there is no transfer of underwriting risk between the reinsured and the reinsurer. Under these contracts, the reinsurers guaranteed a schedule of future settlements on a particular block of business written by the ceding insurer. The ceding insurer can obtain the benefit of discounting reserves arising from the difference between the premium paid and the reserve initially established[28].

b. Loss portfolio transfer agreements

[24] *See* Daniel S. Jones & Richard N. Glaser, *id.* at 9.
[25] *See* REINSURANCE PRACTICE AND THE LAW, *supra* note 5, at 14-6 (Issue No. 14-1 March 2000).
[26] *See id.* at 14-5.
[27] *See* P. T. O'NEILL, & J. W. WOLONIECKI, supra note 23, at 312. *See also* REINSURANCE PRACTICE AND THE LAW, *id.* at 14-5 (Service Issue No. 14-1, March 2000).
[28] *See* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *supra* note 5, at 741.

The early forms of loss portfolio transfers were commonly called "*time and distance contracts*" among the Lloyd's syndicates[29]. The payment of reinsurance recoveries was structured on a financial basis relating to interest and investment of premiums rather than on an indemnity basis corresponding to the actual loss arising from liability to the policyholders. Furthermore, the payment made by the assuming reinsurer was paid in accordance with specified schedules, regardless of the ceding insurer's underlying loss development. As a result, there was no transfer of underwriting risk to the reinsurer.

Following "*time and distance contracts,*" "*loss portfolio transfer*" (LPT) agreements have been developed to transfer liability arising from a particular book of discontinued or expired insurance policies, along with sufficient cash to cover loss and loss adjustment expense to a reinsurer. The premium paid by the ceding insurer is approximately equivalent to the net present value of the loss reserve of the ceding insurer[30]. The reinsurer "assumes not only liability for payment of outstanding losses but also responsibility for handling their ultimate settlement". Therefore, such an agreement can be a "viable and cost-effective alternative to a potentially costly, long term run-off of outstanding claims"[31]. On the other hand, the assuming reinsurer can also obtain the profit of future cash flow arising from investment income on the loss reserve relating to discontinued or expired insurance policies transferred from the ceding insurer. In practice, LPTs allowed the ceding insurer to transfer certain lines of insurance immediately. Additionally, LPTs were often used for the ceding insurer to arrange mergers and acquisitions[32], as well as to expand other lines of business.

c. Retrospective aggregate loss agreements

These contracts which are similar to LPT contracts allow the ceding insurer to transfer both outstanding losses as well as incurred but not reported losses on a block of existing business. Unlike other LPTs, a *retrospective aggregate loss agreements* (RAL) contract provides the ceding insurer with the coverage on a specified portfolio business with an aggregate limit of an agreed amount, usually without any annual limit. The premium is based on the discounted value of an estimated schedule of loss

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[29] *See* Andrew Barile, *Finite Risk Reinsurance,* in Reinsurance's Technical Report, Vol. 25 No. 10, at 7 (Timothy Benn, January 1995).
[30] *See* Swiss Re, *supra* note 14, at 13.
[31] *See* Andrew Barile, *supra* note 29, at 9.
[32] Swiss Re, *supra* note 14, at 15.

payments. Under this contract, "a timing risk is introduced if a contract provides for the payment of ultimate net losses over an agreed amount (or in excess of a specified loss ratio) at the time when they are actually incurred" by the ceding insurers[33].

d. Retrospective excess of loss agreements

"*Retrospective excess of loss agreements*" (RXL), which are also called *adverse development covers* (ADCs)[34], provide the ceding insurer with the coverage for the ultimate cost of outstanding and incurred but not reported losses that exceed a specified amount. In addition, RXLs may extend their cover against losses, which have been incurred but for which inadequate reserves have been made, or cover the credit risk arising from insolvent reinsurers[35].

2. Prospective loss contracts

A "*prospective reinsurance contract*" is one where the reinsurer provides a reinsured with protection in relation to future losses on existing and future business. Prospective contracts can be used to provide protection against catastrophe losses such as windstorms or hurricanes and to smooth fluctuations in a reinsured's business[36]. The premiums paid by the ceding insurer are based on the scope of the underwriting risk and take into account the net present value of loss payments expected during the term of the contract[37].

a. Prospective aggregate excess of loss covers

"*Prospective aggregate excess of loss contracts*", or "*spread loss*" contracts[38], are designed to spread losses in annual net loss experience over time. Under this cover, the ceding insurer pays a predetermined annual premium into an "experience account", which is used to pay for loss payments arising from liabilities of the ceding insurer and should earn investment income that is to be credited to the fund balance. However, if the account can not meet the loss payment, the ceding insurer is to pay higher premiums to compensate part of this account[39]. On the other hand, "such

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[33] *See* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *supra* note 5, at 743.
[34] Swiss Re, *supra* note 14, at 23. *See also* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *id.* at 745.
[35] *See* Swiss Re, *id.* at 17.
[36] R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *supra* note 5, at 741.
[37] *See* Swiss Re, *supra* note 14, at 16.
[38] *See* Andrew Barile, *supra* note 29, at 11. *See also* P. T. O'NEILL, & J. W. WOLONIECKI, supra note 23, at 315.
[39] *See* Swiss Re, *supra* note 14, at 21.

agreement can use profit commissions in which a portion of premium is returned to the ceding insurer in the event the reinsurer suffers no loss"[40]. The main function of this cover for a ceding insurer is that it protects both its income and balance sheet against adverse loss experience up to the reinsurance limit, while a ceding insurer is seeking to either expand new lines of business or to engage in a merger or acquisition[41].

b. Financial quota share reinsurance

Under such an agreement, the ceding insurer transfers a portion of its unearned premiums to the assuming reinsurer and then receives a ceding commission, which is treated as current income and which is intended to increase the ceding insurer's statutory surplus[42]. Unlike quota share reinsurance, the payment does not correspond to the equivalent percentage of claims, although the reinsurer under the financial quota share reinsurance receives a predetermined percentage of the net premiums[43]. In addition, the reinsurer typically limits its liability expressed as an absolute sum or a "loss ratio" or a percentage of reinsurance premiums[44].

B. Regulatory Issues arising from Financial Reinsurance and Finite Risk Reinsurance

While financial reinsurance and finite risk reinsurance may offer several benefits to the ceding insurers, they also raise potential risks, particularly as to the financial solvency of the ceding insurers. Through financial reinsurance that helps smooth the ceding insurer's fluctuations on investment risks rather than on substantial insurance risks, the balance sheet of the ceding insurer and the reinsurer may give a misleading view of its financial positions. Consequently, loss reserves may be inappropriately reduced by the amount of finite risk reinsurance and may be inadequate to meet the payments for liabilities to policyholders. As a result of misleading financial reporting, "the truth and fairness, comparability, and consistency of the published financial statements of insurers and reinsurers may be impaired.[45]" Additionally, in some finite risk reinsurance, such as time and distance policy, it can amount to no more than a

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[40] Andrew Barile, *supra* note 29, at 11.
[41] R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *supra* note 5, at 746.
[42] *See* Andrew Barile, *supra* note 29, at 8.
[43] P. T. O'NEILL, & J. W. WOLONIECKI, supra note 23, at 315.
[44] *See* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *supra* note 5, at 748.
[45] *See* The Institute of Chartered Accountants in England and Wales, *supra* note 21, at 3.

loan facility, in the form of an insurance contract, to postpone the financial impact of claims on the ceding insurers[46].

In some jurisdictions, insurance regulations may prohibit insurers from carrying on any transactions that are not true reinsurance. For instance, in the United Kingdom Section 16 (1) of the Insurance Companies Act 1982 requires that an insurer "shall not carry on any activities, in the United Kingdom or elsewhere, otherwise than in connection with or for the purpose of its insurance contracts." If the reinsurers are conducting transactions that are not reinsurance, then they may "lose their licenses, be subject to penalties or other disciplinary measures, find the contracts unenforceable, and be the subject of actions by shareholders[47]". In addition, the insurer who engages in such a transaction also is subject to relevant investment requirements and solvency regulation.

C. Recent Regulatory Developments and Finite Risk Reinsurance

The dynamic character and complexity of financial reinsurance and late finite risk reinsurance, which could optimize the balance sheet and could contradict the "true and fair view" principle in some cases, has raised accounting, insurance regulation and taxation issues. Consequently, the structure of contract has been affected by the responses of accounting bodies, tax and regulatory authorities[48]. Several attempts relating to the accounting treatment of financial reinsurance and finite risk reinsurance have been made to define what constitutes a reinsurance contract and to analyze the essential characteristics of reinsurance.

1. United States

The rules in 1992 adopted by the US Financial Accounting Standards Board (FASB) were set out in Statement No. 113 (FAS 113). The risk transfer requirement in FAS 113 is that there must be "a reasonable possibility that there is a significant loss to the reinsurer" under a reinsurance contract. Any contract that fails to meet this requirement must be accounted for as a financing transaction. The risk transfer requirements in FAS 113 are referred to as the "9a test" and the "9b test". The former requires that "the reinsurer must assume significant insurance risk (timing and

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[46] *See* Jonathan Miles & Diana Owen, *Accounting For Non-life Financial Reinsurance*, 104 JOURNAL BRITISH INSURANCE LAW ASSOCIATION 16, 17(September 2000).
[47] P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 23, at 315.
[48] *See* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *supra* note 5, at 736.

underwriting risk) under the reinsured portions of the underlying insurance contracts". Additionally, "it must be possible that the reinsurer may realize a significant loss from the transaction.[49]" Although the definition of a significant loss has not been provided the FAS 113, the informal guidelines used to define this criterion is that "a 10%-15% loss (calculated by dividing the present value of all cash flows between the ceding and assuming enterprises with the present value of amounts paid to the reinsurer before commissions) could be considered to be significant"[50]. FAS 113 applies primarily to retroactive reinsurance contracts or loss portfolio transfer contracts under which" an assuming enterprise agrees to reimburse a ceding enterprise for liabilities incurred as a result of past insurable events.[51]"

This was followed by the FASB's Emerging Issues Task Force (EITF Issue 93-6), which further addresses multiple-year retrospectively rated contracts or spread loss treaties. In addition to the risk transfer test of FAS 113, it requires that the contract must be of a short duration and that the premiums expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided [52]. The main purpose of the EITF Issue is to "effectively eliminate the income statement smoothing benefits previously recorded by certain companies under these types of contracts"[53]. This guideline mainly applies to "spread loss treaties" that make use of experience accounts in order to distribute loss payments over time[54].

In order to adopt the concept similar to FAS Statement 113, the National Association of Insurance Commissioners (NAIC) revised Chapter 22 of the "Property/Casualty Accounting Practices and Procedures Manual" for statutory accounting (Chapter 22 NAIC) in 1994. However, it should be noted that the revised

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[49] *See* COOPERS & LYBRAND, REINSURANCE ACCOUNTING UPDATE 1995: A MANAGEMENT GUIDE: A SUPPLEMENT TO IMPLEMENTING FASB STATEMENT 113-A MANAGEMENT GUIDE 2(January 1996). In practice, a rule of thumb has been developed to define whether a contract will qualify for treatment as a reinsurance contract. To meet this rule, there must be at least a 10% chance of a 10% underwriting loss by the reinsurer. *See* Jonathan Miles & Diana Owen, *supra* note 46, at 20.

[50] *See id.* at 7.

[51] *See* Swiss Re, *supra* note 14, at 23. *Also See* COOPERS & LYBRAND, *id.* at 2.

[52] *See* COOPERS & LYBRAND, *supra* note 49, at 16.

[53] *Id.* at 16.

[54] Spread loss treaties are often used by the ceding insurers to pay reinsurers for catastrophe risks. The contracts provide for an initial deposit premium and retrospective rating based on contract experience which is generally tracked through an off-balance-sheet account (a fund balance or experience account). *See* Swiss Re, *supra* note 14, at 23. *See also* COOPERS & LYBRAND, *id.* at 15.

Chapter 22 differs in many ways from FAS 113 and EIFT Issue 93-6, particularly as to retrospective contracts[55]. With regard to the risk transfer criteria, Chapter 22 adopts the same test established in FAS 113. If a contract does not meet the risk transfer risk, the net consideration paid to the reinsurers should be accounted for as a deposit by the ceding insurers. Consequently, such a deposit should meet the requirements of relevant insurance regulations in order to be admitted as an asset in the ceding company's Annual Statement[56].

2. United Kingdom

In the United Kingdom, recent legal development regarding finite risk insurance have taken place as to its accounting, tax and regulatory implications. In this section, three main issues relating to finite risk insurance will be discussed.

a. Accounting treatment for finite risk insurance in the United Kingdom

The first step to develop an appropriate accounting treatment was taken in December 1991 by the Institute of Chartered Accountants in England and Wales (ICA). "Accounting for Non-life Financial Reinsurance: A Discussion Paper" was prepared by the Working Party on Financial Reinsurance set up by the Insurance Sub-Committee of the ICA. This discussion paper addresses several main issues, including the need for guidance, transfer of risk, recognition tests for reflecting the substance of transactions, contract categories, and guidance on the identification of contracts. This paper develops guidance on (a) the transfer of risk and its identification; (b) what should be and should not be accounted for as reinsurance; and (c) the disclosure that should be made in various circumstances[57].

With regard to the need for guidance, it has been observed that "if financial reinsurance is accounted for as conventional reinsurance, the balance sheet of both the ceding company (or reinsured) and the assuming company (or reinsurer) may give a misleading view of their financial positions; published underwriting and operating

[55] For instance, for retrospective reinsurance contracts, Chapter 22 requires that surplus resulting from any such contract should be restricted as a special surplus fund until such time as the liabilities transferred have been recovered or terminated. However, under GAAP, gains on such transactions should be deferred and presented as liabilities and amortized over the estimated settlement period of the underlying insurance contract using either the recovery or interest method. COOPERS & LYBRAND, *id.* at 38. *See also* Daniel S. Jones & Richard N. Glaser, *supra* note 23, at 7-8.

[56] The assuming reinsurers should be appropriately licensed, accredited or otherwise qualified in the ceding insurer's state of domicile. Alternatively, the fund should be established and maintained on the ceding insurer's behalf. *See* COOPERS & LYBRAND, *id.* at 16.

results may also be distorted.[58]" Due to the lack of generally accepted accounting and reporting practices, "the truth and fairness, comparability, and consistency of the published financial statements of insurers and reinsurers may be impaired[59]."

The types of risk described in this discussion paper are divided into (a) underwriting risk, (b) timing risk, (c) investment return risk, (d) credit risk and (e) expense risk[60]. A distinction is drawn between timing risk and investment risk. "The timing risk has a bearing on the level of funds available for investment, where investment income on technical provisions is an integral part of the commercial underwriting result (although generally not part of the published underwriting result). The investment risk relates to the risks associated with the investment function."[61] A contract in the absence of any transfer of underwriting risk and/or timing risk is not sufficient to categorize the contract as one of reinsurance for accounting purposes. However, a contract that transfers no underwriting risk but transfers timing risk is sufficient for the transfer of risk and can be deemed a reinsurance contract[62].

Additionally, this discussion paper provides guidance as to the identification of contracts. A contract should be accounted for as reinsurance if the ceding insurer's insurance risk, including underwriting risk and/or timing risk, has been transferred to the reinsurer. The underwriting risk is transferred to the reinsurers if the reinsurer assumes a specified proportion or percentage of the ceding insurer's incurred claims or exposure to future losses. Furthermore, the terms of the contract, including any adjustable features, should not result in the underwriting margin or deficit being fixed in advances as a specified single amount. There should remain a reasonable degree of

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[57] *See* The Institute of Chartered Accountants in England and Wales, *supra* note 21, at 4.

[58] *Id.* at 3.

[59] *Id.* at 3.

[60] Underwriting risk is that "Uncertainty as to the occurrence of the loss event and/or the ultimate amount of any claim payments". Timing risk arises from "uncertainty as to when gross claims are paid and consequently when reinsurance recoveries will become due to the cedant from the reinsurer." As for investment risk, this paper provides that "the investment return risk is the uncertainty as to the ultimate investment return which a reinsurer will earn, other than by reason of the timing risk, on net moneys accruing under a reinsurance contract". Credit risk is the risk borne by the cedant that the reinsurer, by reason of insolvency or otherwise, does not meet its obligation to pay losses, return premiums or profit commissions under the reinsurance contract." Also the investment risk is borne by the reinsurer on investing premiums received from the reinsured. Expense risk is the risk relating to "uncertainty as to whether expense loadings in the premiums ceded to the reinsurer will be sufficient to meet the operating costs of the reinsurer." *Id.* at 6-7.

[61] *See id.* at 7.

[62] "Because the date of the event triggering the claim and the related reinsurance recovery is not certain." As a result, a contract that only transfers timing risk can be deemed a reinsurance contract. *Id.* at 7.

potential variability in the ultimate underwriting results in relation to the total premiums paid to the reinsurer. On the other hand, if the contract provides for the prompt reimbursement of the claim reinsured by the reinsurer, the contract can be accounted for a reinsurance contract because the timing risk has been transferred to the reinsurer[63].

If the contract does not provide for the transfer of insurance risk, the transaction should not be accounted for as reinsurance. Consequently, the premium paid by the ceding insurer should be accounted for as a cash deposit and not as an underwriting transaction[64]. The reinsurer should account for the amount repayable to the ceding insurer as a liability. As a result, "the difference between the consideration paid by the ceding insurer and the recoveries expected to be received from the reinsurer should be amortized over the period of the contract by each party as investment income or interest expense, as appropriate"[65].

Following this ICA discussion paper, the ICA issued its Financial Reporting Exposure Draft, "Reporting the Substance of Transactions" (FRS5), in order to require the clear disclosure in accounts of the substance of transactions. In 1994, a Technical Release on the "Application of FRSS5 to General Insurance Transactions" (FRAG 35/94) was then provided by the Institute. This indicates that "an element of either underwriting risk or timing risk would be sufficient for a contract to qualify as a reinsurance and to be accounted for as such"[66].

In relation to accounting standards, the "Statement of Recommended Practice for Accounting for Insurance Business" (SORP) that places the emphasis on the economic substance of a contract rather than its form was proposed by the Association of British Insurers (ABI) in December 1998[67]. This states that "the economic substance of a general insurance transaction should be reflected in the result for the year and the balance sheet[68]". With regard to the determination of the economic substance of an insurance transaction, it has been observed that:

"In considering whether or not a significant transfer of insurance risk has

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63 *Id.* at 16.
64 *Id.* at 17.
65 *Id.* at 18.
66 *See* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *supra* note 5, at 737.
67 *Id.* at 738.
68 *Id.* at 738.

taken place under a contract of insurance, the entity should consider first whether it is reasonably possible that the insurer may realise a significant loss from the contract, and secondly, whether there is a reasonable possibility of a significant range of outcomes under the contract. If there is a significant degree of uncertainty in respect of the timing of claim payments then, depending on the effect of the contract as a whole, timing risk alone may be sufficient to constitute a transfer of insurance risk.[69]"

b. Tax and regulatory implication in the United Kingdom

The FSA IPRU (INS) Chapter 5, Rule 5.2 (1) provides that "the amount of liabilities of an insurance company is respect of long term and general business shall be determined in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies". With regard to generally accepted accounting concepts, bases and policies or other generally accepted methods, FRS 5 taken with FRAG 35/94 and the SORP recommended by the ABI may be regarded as "generally accepted accounting methods" in defining what constitutes a reinsurance contract and insurance risk[70]. Furthermore, the FSA IPRU (INS) Appendix 9.2, paragraph 26, which provides the form of insurance companies' annual returns to the FSA, requires that amounts in respect to inwards and outwards contracts of insurance must be classified for inclusion in the relevant forms "according to their economic substance in accordance with generally accepted accounting practice.[71]"

In relation to the positions of the Department of Trade and Industry (DTI), HM Treasury[72], and the Financial Services Authority, these bodies have emphasised the need for full disclosure and for adequate accounting treatment of financial reinsurance and finite risk reinsurance. The DTI wrote several letters to authorised insurance companies to clarify some regulatory requirements relating to financial reinsurance and provided specific guidance.

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[69] *See* Omar Hameed, *supra* note 6, at 8.

[70] *See* Ian Mathers, *Financial Reinsurance: United Kingdom Regulatory Implication*, INTERNATIONAL INSURANCE LAW REVIEW Vol. 6 Issue 8, 247, 248(1998).

[71] FSA, Interim Prudential Sourcebook: Insurers Vol. 2, Appendix 9.2, paragraph 26.

[72] Although there is no provision in the Insurance Company Act for the Treasury to give an authoritative ruling on the scope of the authoristaion requirement or the prohibition in section 16 of non-insurance activities, the regulation of insurance and reinsurance companies by the Treasury is accomplished through the annual return. *See* Ian Mathers, *id.* at 248. *See also* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 23, at 323.

In its Letter dated 22 June 1992[73], the DTI provides with specific guidance on prospective aggregate excess of loss contracts (spread loss contracts). In relation to the recognition of liabilities under a spread loss contract, the effect upon the technical account balance must be considered. A contingent or prospective liability should be taken into account in accordance with Regulation 52(2) of the Insurance Companies Regulations 1981 if the statement of balance shows an adverse balance. The Director's letter dated 26 May 1995 refers to FRAG 35/94 and states that the regulator "expects the guidance in FRAG 94 to be followed..... assets and liabilities should be adequately disclosed..."[74].

Although the Financial Services Authority, the Treasury and the DTI have shown considerable concern regarding the disclosure and reporting of finite risk reinsurance and financial reinsurance, relevant precise guidance, in defining when a contract should be deemed a reinsurance contract have not been developed yet by the UK regulators [75].

D. Implication of Reinsurance Regulation and Finite Risk Reinsurance: A Comparative Analysis

From the viewpoint of regulators, the main concern is whether finite risk reinsurance will result in misleading statutory reporting through the deterioration of an insurer's loss reserves. In general, developed regulation and accounting standards focus on the "economic substance" of the transactions, although a definition of "economic substance" and the treatment of specified transactions may differ.

In comparing the two leading developed country models, the main difference that exists is in the determination of what constitutes insurance risk. Under the US model, the essential components of insurance risk include underwriting risk and timing risk according to FAS 113. In contrast, in the UK, insurance risk may comprise either underwriting risk or timing risk in accordance with the FRAG 35/94. As a result of a timing risk that can constitute insurance risk alone, spread loss transactions focusing on timing risk can be deemed a reinsurance contract in the UK, whereas the same transaction would be deemed as a "deposit arrangement" rather than a

[73] *See* REINSURANCE PRACTICE AND THE LAW, *supra* note 5, at 14-14 (Issue No. 12-1 March 1999).
[74] *Id.* at 14-15.
[75] *See* P. T. O'NEILL, & J. W. WOLONIECKI, *supra* note 23, at 324.

reinsurance contract in the US.

Furthermore, another difference arises from the regulatory structure of financial reporting obligations and results in different treatment for the specified transactions. In the United States, FAS 113 is applied to enterprises, whereas the model statutory accounting Chapter 22 issued by NAIC is applied to insurance enterprises for the purpose of solvency regulation. Statutory accounting principles and "general accepted accounting principles" (GAAP) in general differ significantly on the treatment for the realisation of expenses, but are similar with regard to the realisation of revenues[76]. As a result, treatment for the same finite risk reinsurance may differ. For instance, any gain arising from retrospective covers is deferred and recognized on either the interest method or recovery method. As a result of Chapter 22 based on the purpose of the solvency regulation, the treatment for retrospective loss contracts focuses on adequacy of capital. Therefore, any gain from retrospective loss contracts is shown as other income and separated as special surplus until recoverables are realised in accordance with Chapter 22[77]. It should be noted, however, that this different reporting treatment would impose a burden on insurance enterprises to submit two sets of financial reports. Under the UK model, the definition of "economic substance" of an insurance transaction is determined by the generally acceptable accounting concepts that can be taken into account with FRS 5, FRAG 35/94 and SORP in accordance with the FSA IPRU (INS). With regard to the treatment for these transactions, the UK regulators have a tendency to narrow the gap between the statutory accounting and UK "generally accepted accounting principles" by moving such transactions from the revenue account into the balance sheet[78]. As a result, in 1995, the DTI proposed to make explicit provision that "inwards and outwards financial reinsurance will be treated in the DTI in according to the same principles as apply in the shareholder accounts".[79] It is likely that the Financial Services Authority will provide further specified statutory accounting treatment for these transactions based on the UK trend of coordination of accounting methods among relevant governmental authorities.

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[76] *See generally* MICHAEL W. ELLIOTT, BERNARD L. WEBB, HOWARD N. ANDERSON & PETER R. KENSICKI, PRINCIPLES OF REINSURANCE VOL.2, at 169-170 (Insurance Institute of America, Pennsylvania, 2nd edition, 1995).
[77] *See* Daniel S. Jones & Richard N. Glaser, *supra* note 23, at 6-7.
[78] *See* REINSURANCE PRACTICE AND THE LAW, *supra* note 5, at 14-11.
[79] *See id.* at 14-15.

In addition to accounting structural difference between the UK and the US, FAS 113, EITF Issue 93-6 and Chapter 22 issued by NAIC prescribed more specified treatments for finite risk reinsurance than the accounting standards and statutory requirements provided in the United Kingdom. First, FAS 113 prescribes different accounting treatments for prospective and retrospective loss contracts. For prospective loss contracts, reinsurance premiums are required to be treated as prepaid premiums and are to be amortised over the remaining contract period. On the other hand, the premium paid for retrospective loss contracts are required to be reported as reinsurance receivables to the extent that they do not exceed recorded liabilities relating to the reinsurance insured. Under UK GAAP, prospective and retrospective reinsurance contracts are treated in a similar manner to the treatment of prospective reinsurance under US GAAP[80]. Moreover, there is no specified accounting guidance for multiple year, retrospectively rated contracts in the UK, whereas US EITF 93-6 prescribes specific accounting treatment for these agreements. In the absence of specified accounting guidance in the UK, the DTI wrote its letter dated 22 June 1992 that contains specific guidance regarding spread loss contracts and technical accounting balances.

Although accounting principles have been developed to deal with finite risk reinsurance and financial reinsurance, weakness still exists in these developed models. There may be conflict arising from the definition of reinsurance. The approach developed by accounting bodies and relying on the "economic substance" of transactions may be different from the decision made by a court, that may be asked to define reinsurance based on the legal concept such as subject matter or insurance interest. In addition, the issues relating to finite risk reinsurance and technical provisions should be considered *prudentially*. For the purpose of solvency regulation, the requirement of technical provisions is designed to ensure that insurers can meet the liabilities arising from the insurance policies and relevant losses. With respect to certain finite risk reinsurance transactions, which assume limited underwriting risk, the reliability of such transactions and the adequacy of loss reserves should be appropriately considered even though these transactions formally meet the criteria for a reinsurance contract. For instance, under a spread loss contract, if actual loss payment exceeds the estimated payment based on the reinsurance premiums, the

[80] *See* Jonathan Miles & Diana Owen, *supra* note 46, at 21.

insurer is obligated to pay a further reinsurance premium to compensate the additional loss payment. As a result of the possibility of a further premium for loss payment, it has been suggested that a reserve should be held for the amount of this contingent liability[81]. Therefore, it is important to develop methods to estimate the extra reserve, taking into account reinsurance contracts regarding the terms, commission provision and other relevant provisions that can substantially affect the loss payment and any further reinsurance premium.

To develop appropriate regulation governing the finite risk reinsurance, the following aspects should be considered:

First, basic criteria relating to risk transfer should be developed to enhance the transparency of the relative regulation as to the insurers and reinsurers. This criteria could be based on the "economic substance" of the transactions or so called "a significant risk transfer" and "a possible loss" provided by FSA 113. With regard to risk transfer criteria, it would be appropriate that timing risk alone is sufficient to constitute a reinsurance because the timing risk arising from the uncertainty of liability payment for policyholders will significantly affect the capacity of the ceding insurers. This will provide more flexible and less stringent regulatory requirements for insurers who suffer the timing risk arising from the assumed insurance risk. In addition to development of risk transfer criteria, it should be noted that the criteria based on the accounting principles should not be inferred as to what constitute the reinsurance contract in law and should only be used to decide the appropriate accounting and regulatory treatments.

Secondly, the issue relating to the economic substance of transactions should take into account the relevant contractual terms that may affect the loss payment from the reinsurers and further reinsurance premiums to be paid by ceding insurers, (*e.g.*, experience account, the premium payable estimated by reference to a stated or implied interest rate, a return of profit commission, cancellation or commutation provisions that would result in a loss to the ceding insurers). This should take into account the terms of reinsurance contracts as a whole and the analysis of the financial outcome relating to the transaction, although this may increase the regulatory costs

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[81] *See* R. C. WILKINSON, D. H. CRAIGHEAD, J. W. DEAN, A. H. SILVERMAN, P. K. CLARK & M. G. WHITE, FINANCIAL REINSURANCE OF GENERAL INSURANCE, at 17 (Institute of Actuaries, UK, 1993) (unpublished a discussion paper presented to the Institute of Actuaries on 27

and may place undue burdens on the regulators in monitoring and analysing these transactions. Accordingly, the cooperation between auditors, tax authority and insurance regulators should be enhanced.

Thirdly, while one of the characteristics of finite risk reinsurance is being multi-year, the security/creditworthiness of reinsurance transactions (i.e., financial viability of reinsurers) is the main issue relating to reinsurance regulation. These transactions often involve huge amounts of reinsurance premiums, with payments being distributed over several years. For example, under loss portfolio transfer agreements, the payment of reinsurance recoveries is structured on a financial loss event and is distributed along with the investment income during the covered period. The financial condition of the reinsurer will have a significant impact on reinsurance recoveries. Furthermore, reinsurers who specialise in the area of finite risk reinsurance are often located and registered in less stringent regulated jurisdiction such as Bermuda and the Cayman Island. This situation increases the concerns for the creditworthiness of reinsurers. Therefore, the regulators should be able to assess the reliability of such a transaction and the financial solvency of the reinsurers.

Fourthly, the adequacy of loss reserves should be considered even though the reinsurance transaction meets the risk transfer criteria. The main advantage of finite risk reinsurance is the reduction of loss reserves after finite risk reinsurance cover was provided. While finite risk reinsurance may lead to an inadequacy of loss reserves, it is essential to develop methods to estimate the extra reserves and to analyse the possible effect of the contractual terms on the insurer's financial solvency.

II. Securitisation of Insurance Risk and Relevant Regulatory Issues

The first step towards the securitisation of insurance risk began following the shortage of reinsurance capacity caused by a series of severe catastrophes in the early 1990s[82].

Feb.1993),.

[82] With regard to catastrophes in the 1990s and their impact on insurance industry, it has been observed by US Insurance Service Office that:
"In 1992, when Hurricanes Andrew and Iniki struck, a record sixty-three property/casualty insurers became insolvent. Fifteen of those insolvencies were directly attributable to the losses those storms caused in Florida, Louisiana and Hawaii. In the nine years and ten months from January 1989 to October 1998, the US property/casualty industry suffered an inflation-adjusted $98.0 billion in catastrophe losses-101.2% more than the inflation-adjusted $48.7 billion in catastrophe losses during the 39 years from January 1950 to December 1988." In addition, "the population in parts of the United States exposed to hurricanes and earthquake rose 24.5% from 1970 to 1990, as the population other areas of the country rose 20.7%. And, based on demographic projections provided by NPA Data Services, Inc., the population of areas exposed to catastrophe will rise another 36.6.% from 1990 to

Consequently, the hardening of the reinsurance market for catastrophe loss coverage compelled insurers to look for an alternative source of capacity and caused reinsurers to look for alternative means of risk financing capital[83]. To deal with this situation, insurers and financial institutions began to develop ways of securitising catastrophe risk to attract additional capital from investors and the capital market[84]. After learning from the successful "mortgage backed securities" transactions in the early 1980's[85], the major landmark insurance-linked securities to carry a rating on the underlying catastrophe risk-USAA (United Services Automobile Associations, USAA) /Residential Reinsurance transaction, was launched in June 1997[86], providing USAA with the coverage of a single hurricane. Subsequent insurance-linked securities and similar insurance securitisation structures were developed as an alternative risk transfer mechanism to conventional reinsurance and provided insurers with the coverage of earthquake, hurricane, windstorm, credit insurance, bankrupcy, temperature risk[87] and life insurance risk arising from mortality, expense fees and acquisition costs[88].

2025. " That means that "exposure growth in those areas increase potential catastrophe losses". *See* Insurance Services Office, *Financing Catastrophe Risk: Capital Market Solutions*, (January 1999), available at<www.iso.com/docs/stud013.htm>(18 August 2000 visited). *See also* Garry Booth, *Catastrophe Bonds*, in INSURANCE RISK SECURITIES- A GUIDE FOR ISSUERS AND INVESTORS 47, at 48 (Garry Booth & Charles J. Allard Jr., ed., 1999).

[83] *See* INSURANCE RISK SECURITIES- A GUIDE FOR ISSUERS AND INVESTORS, at 16 (Garry Booth & Charles J. Allard Jr., ed., 1999).

[84] It has been estimated that fifteen property and casualty insurers became insolvent and were directly affected by the catastrophes in Florida, Louisiana, and Hawaii. *See* Insurance Services Office, *supra* note 82.

[85] In order to meet the need to finance collections of mortgages, as early as 1938, The Federal National Mortgage Association (Fannie Mae) started to issue debt guaranteed by the Federal Government of the United States. As a forerunner to mortgage securitisation, many companies gathered government guaranteed mortgages, packaged them "whole" and sold them to private investor as a new hedge tool. *See* Charles J Allard Jr., *The Development of Risk Securitisation*, in INSURANCE RISK SECURITIES- A GUIDE FOR ISSUERS AND INVESTORS 33, at 21-22 (Garry Booth & Charles J. Allard Jr., ed., 1999).

[86] By gaining double B ratings from the main rating agencies, this transaction successfully represented that insurance-linked securities had become the significant part of investment grade securities and had opened up the market to diversify the investors' portfolio. *See* INSURANCE RISK SECURITIES- A GUIDE FOR ISSUERS AND INVESTORS, *supra* note 83, at 17. *See also* Michael S. Canter, Joseph B. Cole and Richard L. Sandor, *Insurance Derivatives: A New Asset Class for the Capital Markets and a New Hedging Tool for the Insurance Industry*, Hedge Financial Products Inc. (10 March, 2002) *available at* <http://www.cnare.com/rescenter/s2k_reports/s2k_insderivatives.htm>.

[87] *See* Bertil Lundqvist, *supra* note 7, at 801.

[88] With regard to acquisition costs, for instance, the UK mutual life insurer National Provident Institution (NPI) in 1998 securitised the future profits of a block of its life insurance policies through Mutual Securitisation Plc which provided cash flow for NPI and improved its financial flexibility to expand its business. *See* Richard H. Bernero, *Second Generation OTC Derivatives and Structured Products: Catastrophe Bonds, Catastrophe Swaps, and Life Insurance Securitizations*, in SECURITIZED INSURANCE RISK STRATEGIC OPPORTUNITIES FOR INSURERS AND

A. General Structure of Securitisation of Risk

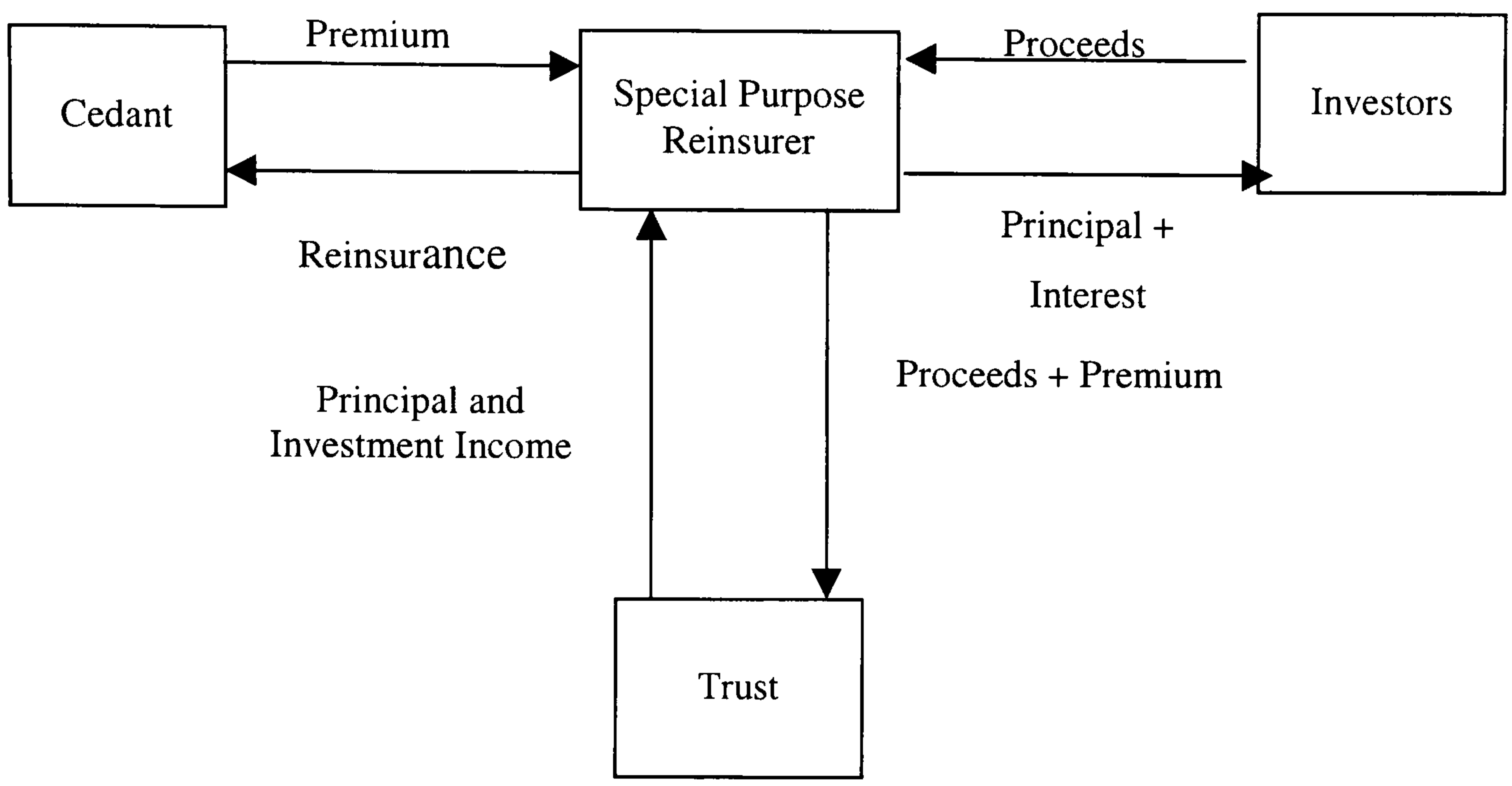
The majority of insurance securitisation involves the transfer of catastrophe risk from the ceding insurer which has underwritten and transferred catastrophe risk to investors who in turn purchase the insurance-linked securities to fund the ceding insurer's risk exposure. Additionally, insurance-linked securities have been developed to provide coverage of life insurance risk relating to mortality, expense fees and acquisition costs.

In a typical insurance securitisation, a special purpose reinsurers (SPR) will be structured and formed as the issuer of insurance-linked securities and the insurer or the reinsurer who underwrites an insurance or reinsurance contract for the insured, insurer, or reinsurers. Although it might be more effective to transfer insurance risks to the capital market directly by means of issuing insurance-linked securities to the investors, the SPR is often necessary because of legal circumstances (*e.g.*, concern for "bankruptcy" and relevant regulations) and taxation concerns. SPRs, in practice, have often been established in Bermuda or the Cayman Islands, which subject them to lower minimum required levels of surplus and capital and a generally reduced level of regulatory scrutiny, auditing and financial reporting requirements[89]. The typical structural model regarding cash flow and contractual relationships for those insurance securitisation transactions are illustrated as follows:

INVESTORS 39, at 64-73(Michael Himick ed., Glenlake, Chicago 1998).

[89] *See* Bertil Lundqvist, *supra* note 7, at 810. *See also* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *supra* note 2, at 96-99.

General Structure of Insurance Securitisation



The SPR assumes the risk from the business underwritten by insurers through insurance or reinsurance contracts and is formed as an issuer for the insurance-linked securities in order to fund its risk exposure under such insurance or reinsurance contracts. The ceding insurers pay the premiums of the reinsurance contracts to SPR, and these premiums combined with the payment from investors generally will be held in the trust. Thus, effectively, this trust holds substantially all of the SPR's assets[90]. The investment earnings on the invested assets in the trust then will be used to pay the SPR's expense, reinsurance claims from the ceding insurers and the return on the securities (i.e., include the full principal plus interest payments).

In relation to the investing bondholders, the return on the securities may be structured on the basis of "(I) the occurrence or nonoccurrence of one or more referenced event, (II) the performance of a referenced industry index, or (iii) the experience of an actual or hypothetical portfolio of insurance business."[91] In addition, "the securities can either be subject to principal invasion or be principal protected with variable coupon and/or extension of maturity providing the underlying risk funding"[92]. For instance, if a catastrophe occurs or the performance index goes beyond the limit, investors may lose all or a portion of their principal.

[90] *See* Bertil Lundqvist, *supra* note 7, at 805.
[91] *See* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *supra* note 2, at 81.

B. Advantage of Securisation of Risk

From the viewpoint of investors, "insurance-linked securities can offer investors attractive returns while providing a way of reducing the overall risk of their portofolio"[93]. In comparison with other rated fixed income securities, catastrophe bonds in their early stages of development have yielded a "spread" over the London Inter-Bank Offered Rate (LIBOR). Even after the market has matured and the advantages of lower premiums would disappear or at least shrink, profitable opportunities may arise again when the capacity of the reinsurance market dries up and pricing tightens[94].

Catastrophe bonds and other types of insurance securities can provide an effective way to diversify their traditional investment portfolios, (*e.g,* stocks, corporate bonds, property, commodities and cash). The return on catastrophe-linked securities, which are generally uncorrelated to economy or to other existing investments, may be considered as "Zero-beta" assets[95]. Noncorrelation indicates that the circumstances that cause fluctuations in the performance of some investments will not have an adverse impact on those that do not correlate. Thus, catastrophe-linked securities, which would not be affected by the overall fluctuations of the stock market and other factors such as interest rate and foreign exchange rates, can be treated as risk hedges and investment instruments that offer diversification potential to investors[96].

In addition, "the randomness of natural catastrophes is actually less susceptible to insider information, moral hazard and potential pricing difficulties than other high-yield corporate bonds."[97] In order to reduce company-specific loss experience and to improve the analysis of loss probabilities, some catastrophe bonds are even designed to link industry losses or other parametric factors (*i.e.* the Richter

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[92] *See id.* at 81.
[93] SWISS RE (New Market), INSURANCE-LINKED SECURITIES 19 (1999).
[94] *Id.* at 19.
[95] As a matter of fact, the correlation of annual percentage changes of the S&P 500 equity index and catastrophe losses was close to zero (r=-0.05, t=-0.33) between 1949 and 1996. Joseph Cole, *Insurance Risk-Securitisation-The Best of Both Worlds*, Risk Publication, (1999)(10 October 2000), available at<www.financewise.com/public/edit/riskm/insure/ins-securit.htm>.
[96] *See* Bertil Lundqvist, *supra* note 7, at 804.
[97] Joseph Cole, *supra* note 95. *See also* R. L. CARTER, LEALIE LUCAS, & NIGEL RALPH, *supra* note 5, at 757.

scale levels of earthquakes or the Saffir Simpson scale levels of hurricanes)[98]. This innovation in programme structuring by developing a parametric trigger mechanism delivers several advantages for investors. Firstly, the parametric trigger, which can be determined within days, offers investors greater certainty and objectivity[99]. Secondly, the transparency of pricing these insurance-linked securities can be enhanced because the trigger mainly depends on the physical probability of the occurrence of the catastrophic event. As a result, investors do not need to have an intimate knowledge of the composition of issuers and details of issuers' portfolio of business[100]. Thirdly, it may reduce the scope of "moral hazard". In practice, insurers may tend to exert some degree of control over their losses (*i.e.* mitigation measurers, loss cost). The greater the moral hazard arising from insurer's control of the loss trigger the greater the payment will be. Therefore, the parametric trigger mechanism, which is often beyond the insurer's control[101], can help reduce the moral hazard of insurers.

From the insurers' perspective, insurance securitisation provides the advantage of moderating the price volatility of reinsurance and bringing stability to the insurance industry after a major disaster which often causes a shortage of insurance industry capacity[102]. In addition to the advantages providing greater capacity to underwrite more risk with a given level of capital, insurance-linked bonds can offer special features, such as multi-year reinsurance programmes. For instance, it is unlikely that a large exposure to a California hurricane risk or a Tokyo earthquake risk could be transferred to reinsurers through conventional reinsurance programmes, but these can be covered with insurance-linked securities[103]. Furthermore, the credit quality is a key

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[98] With regarding to deals in the recent years, the trigger of the USAA/Residential Re transition in 1997 was structured to link the Saffir Simpson scale. In the same year, a SPV named SR Earthquake Fund simultaneously issued $ 137 million notes and entered into a $112.2 million contract with Swiss Re based on an industry loss index of California earthquake losses determined by P.C.S. (Property Claim Services). In 1999, the Oriental Land/ Concentric Re transaction which cover the earthquake losses around the Disney theme park near Tokyo also was designed to link the parameters (location and severity) of the triggering earthquake. *See* Joseph Cole, *id. See also* Alan Punter, *Innovations in Insurance Linked Securitisation*, RISK FINANCIER Vol.4 no. 6, 8, at 9-11 (June 2000); SWISS RE (New Market), *supra* note 93, at 7-18.

[99] *See id.* at 10.

[100] *See* Alan Punter, *supra* note 98, at 11.

[101] When a trigger of insurance-linked bond are determined by industry loss index such as PCS index, moral hazard remains a concern. Because PCS index is based on surveys, it is possible to manipulate reports and information relating to actual losses by insurers. As a result, moral hazard still exists. *See* Kenneth Froot, *Key Ingredients for a Successful Cat Bond Issue*, in INSURANCE RISK SECURITIES- A GUIDE FOR ISSUERS AND INVESTORS, at 67-68 (Garry Booth & Charles J. Allard Jr., ed., 1999).

[102] Bertil Lundqvist, *supra* note 7, at 803.

[103] *Id.* at 804.

advantage that insurance-linked securities can provide while insurers seriously consider credit risk with respect to traditional reinsurance programmes. Insurance-linked securities can be structured to minimize credit risk. For example, insurers can specify that the bond proceeds are invested in highly rated investment grade securities to be held as collateral in a SPV[104].

C. Limitation and Disadvantage of Insurance Securitisation

An insurer or insured can use a customised approach to securitising catastrophe or other risk to strengthen their financial structure and to expand their business. High transaction costs, however, is the main obstacle for an insurer or insured in securitising their risks. Unlike other standardised, exchange-trade catastrophe options[105] that may offer lower transaction costs, the insurers or insured who securitise their risks may encounter considerable administrative expense. In practice, these expenses generally include "the definition of the full condition of the insurance-linked securities, the drafting, finalisation and distribution of the issue prospectus, and finally the placing of the bonds"[106] Legal, accounting and investment expenses may be especially high.

Due to insurance securitisation transaction based on the multiple-year contract, it is difficult for the insurer to alter the transaction and to amend the conditions of the underlying contract to adopt to risk developments in its insurance business before the maturity of the insurance-linked securities. In addition, the parametric trigger mechanism that is often used on a risk securitisation transaction can significantly reduce moral hazard from the ceding insurer, but may result in "basis risk"[107] arising

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[104] *See* SWISS RE (New Market), *supra* note 93, at 17. *See also* Stephen Walker, *The Fusion Of Insurance And Capital Markets*, RISK FINANCIER Vol.4 no.6, 5, 5 (June 2000). Bertil Lundqvist, *id.* at 804.

[105] Typically, exchange-traded catastrophe options are standardised contracts that provide "the purchaser the right to a cash payment if a specified index of catastrophe losses for a specific period reaches a specified level –the strike price." Though purchasing these options, an insurer can use this type of securitisation to hedge catastrophe risk or other relevant risk. In practice, these options can be traded on the Chicago Board of Trade which use PCS industry loss estimates and the Bermuda Commodities Exchange which are based on a family indexes created by Guy Carpenter & Company (GCCI). *See* Insurance Services Office, *supra* note 82. *See also* Sylvie Bouriaux & Michael Himick, *supra* note 11, at 23-37.

[106] *See* Fred Wagner, *Risk Securitzation-An Alternative of Risk Transfer of Insurance Companies*, in THE GENEVA PAPERS ON RISK AND INSURANCE Vol. 23 no. 89, 574, 595(October 1998).

[107] "The term-"basis risk" is used to define the difference that exits between a hedger's (the purchaser of the option) loss experience and the loss experience used by the index that underlies the contract. Since contract settlement values are predicated on the index value at settlement time, the hedger's actual loss experience may differ significantly from the index; the greater the difference, the less

from a mismatch between the insurer's actual experience and the cover provided by the insurance-linked securities.

D. Regulatory Issues relating to Securitisation of Risk

In a typical insurance securitisation transaction, the SPR which is an special legal structural vehicle, will be a party to detailed and complex agreements that focuses on two primary contractual relationships: first, the SPR's relationship with the insurers based on reinsurance contracts and second, the SPR's relationship with bondholders based on issuing of insurance-linked bonds.

In relation to the ceding insurer who transfers its risk to a SPR, the main contractual relationship is based on the reinsurance contract. In practice, other ancillary agreements would include (1) a collateral security agreements to provide security of claims by the ceding insurers, (2) a claims review agreements to review the claims made by the ceding insurers, (3)an administrative services agreements relating to the SPR, and (4)an investment administrative agreements to control the investment of the collateral for claims[108]. Furthermore, another concern of the ceding insurers is that the ceding insurers will be able to reduce their technical reserves by the amount of reinsurance provided by the SPR. Therefore, the reinsurance contracts between the SPR and the ceding insurers should be drafted as a typical reinsurance arrangement governed by applicable insurance laws.

With regard to the bondholders, they are generally concerned with the terms of the bonds themselves, the relevant trust deed that is entered into between the issuer and a trustee on behalf of the bondholders, the security documents and the contractual arrangements. From a securities law regulatory perspective, the SPR will be required to make the "appropriate information and disclosures regarding the SPR itself and the nature and risk of the bond on offer"[109].

1. Issuance of insurance-linked securities

The issuance of insurance-linked bonds by an authorised insurer may give rise to regulatory concerns and arguably may be deemed a reinsurance contract business in

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effective the hedge." *See* DONALD J. RIGGIN, RISK FINANCING IN THE 21st CENTURY: SECURITIZATION AND FINANCIAL REINSURANCE 5 (International Risk Management Institute, Dallas, 1998).

[108] *See* Michael Graham, *Legal Issues*, in INSURANCE RISK SECURITIES- A GUIDE FOR ISSUERS AND INVESTORS 89, at 89 (Garry Booth & Charles J. Allard Jr., ed., 1999).

most jurisdictions. With respect to the liabilities of the issuers, it will be necessary to describe and disclose the risks of loss on the insurance-linked securities in most jurisdictions. Due to the lack of insurable interest in these securities, these arrangements could arguably be construed to be "wagering contracts" under common law principles[110], which might cause them void and/or illegal. Three main issues relating to issuance of insurance-linked securities will be discussed further as follows.

a. Insurance contract and insurance-Linked securities

As a result of the similarity of a insurance-linked securities' function to other reinsurance contracts that assume an insurer's risks, it is conceivable that investors in insurance-linked securities could be deemed to be conducting an insurance business and consequently could be subject to insurance regulations. If the investors were deemed as to be carrying on an insurance business, they could be found to be operating without appropriate authorisation or licenses[111]. Consequently, in such a situation, insurance-linked securities would not be enforceable against the issuing-SPR and the investors may be subject to civil law or criminal statute[112].

There is limited regulatory and judicial guidance relating to the definition of the "business insurance" and the definitions contained in most jurisdictions are too broad to be drafted with the concept of capital market securities in mind[113]. Nevertheless, it is still arguable to say that an investor would not be deemed to be conducting an insurance business by investing insurance-linked securities. In comparison with the definition of insurance business, it has been observed that "securities should not be deemed to be conducting insurance business because they involve a one-time investment prior to and irrespective of loss occurrence, and as a

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[109] *See* Michael Graham, *id.* at 98.

[110] The common law definition of a "wagering contract" is "two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, upon the determination of that event, one shall win from the other, and the other shall pay over or hand to him, a sum of money or other stake...", *Carcill v. Carbolic Smoke Ball Co.*, 2 QB 484, 490-491 (1892), cited with approval in *City Index Ltd v. Lesile*, BCLC 643 (1991). Derived from E. Massock, C. Scales, J. Abramson, J. Irving, M. C. Veed, G. Leal, R. J. Cata, A. Borrell, I. Kawaley, and L. Savitt, *Recent Developments in International Tort and Insurance Law and Practice*, 34 TORT INSURANCE LAW JOURNAL 519, 538 (ABA, Winter 1999).

[111] *See* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *supra* note 2, at 108.

[112] *See* Michael Graham, *supra* note 108, at 97.

[113] *See generally* Andrew S. Rowen & William D. Torchiana, *Outline of Legal Issues for Insurers and Reinsurers Considering Securitization of Insurance Risk*, in Nuts & Bolts of Financial Products 2000, 269, 279 (Corporate Law and Practice Course Handbook Series PLI Order No. B0-00FG, 1164PLI/Corp269, Practising Insurance Institute, February 2000). *See also* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *supra* note 2, at 81.

result the investor can not be liable for additional payment thereafter"[114]. Furthermore, in relation to insurance interests, if insurance-linked securities are designed to be based on an industry-wide losses or an index rather than actual losses of the ceding insurers, then this will distance the link between the payment of investors and the underlying loss suffered by the SPR under the reinsurance contracts. Thus, all these factors should substantially reduce legal uncertainty and legal risk of the securitisation transactions being constituted as an insurance contract[115].

This issue will be determined by reference to the laws of the jurisdiction in which the issuer of insurance-linked securities (SPR) is located and the securities are distributed.

b. Securities laws relating to liabilities of the issuers

In some jurisdictions, the persons participating in a "distribution of securities" are usually liable for inadequate disclosure and the terms of issue of the bond will be required to contain sufficient protection for investors. In this context, the jurisdiction in which the SPR is located is important.

"The prospectus or other offering material in relation to the bonds will need to contain full and fair disclosure of the terms of the bonds, the underlying reinsurance business to which they relate and the risks to investors of investing in these securities, particularly where their principal is at risk.[116]" In addition, the subordination of claims that the bondholders may have against the SPR issuer to the claims of the ceding insurers should be disclosed, particularly in jurisdictions where policyholders have priority over other investors[117].

c. Wagering and gambling issues

Many countries have civil laws rendering gambling and wagering contracts unenforceable and have criminal statutes subjecting the violating parties to

[114] *See* Andrew S. Rowen & William D. Torchiana, *id.* at 281.
[115] *See* Katherine Coates, Hilary Evenett & Cheryl Ronaldson, *Securitising Insurance Risk: Legal Implication*, PRACTICAL APPLICATION OF FINANCIAL MARKET TOOLS TO CORPORATE RISK MANAGEMENT 35 (Emap Finance, 1997). *See also* Omar Hameed, *supra* note 6, at 9. It should be noted that it would increase the basis risk arising from mismatch between actual loss of the ceding insurers and the payment of reinsurance from SPR.
[116] Katherine Coates, Hilary Evenett & Cheryl Ronaldson, *id.* at 36. *See also* Omar Hameed, *id.* at 9.
[117] *See* Michael Graham, *supra* note 108, at 90. *See also* Katherine Coates, Hilary Evenett & Cheryl Ronaldson, *id.* at 36.

prosecution[118]. These laws generally prohibit contracts or arrangements that provide for the making of payments based on a fortuitous event beyond the control of the parties. With regard to insurance-linked securities based on the occurrence of an external event such as a catastrophe or other indices beyond the control of the parties, these transactions would be construed as wagering contracts under these circumstances. As such, it is arguable that the concept of gambling and wagering contracts might be implicated to a broad range of financial investment tools such as interest swap, future and options[119]. It generally is believed, however, that the statutes relating to gambling or wagering do not apply to financial investment instruments as well as insurance-linked securities because they are deemed "commercial contracts" exempt from laws or regulations relating to wagering, gaming and gambling[120].

2. The structure of special purposes reinsurers (SPR)

In most jurisdictions, a SPR is required to obtain authorisation or licenses to carry on insurance or reinsurance business. Furthermore, in most countries, a SPR is prohibited from carrying on non-insurance business that may include any activities relating to issue insurance-linked securities[121]. That explains why SPRs historically have been licensed as restricted insurers in the Cayman Island, or Guernsey, where statutes have adopted the concept of the segregated portfolio or "cell company", or in Bermuda, which permits a similar concept of designated investment contracts[122]. Following a growing recognition of the advantages of insurance securisation from insurers, investors and regulators, attempts are been made to facilitate securisation transactions operated domestically by introducing a similar concept to the "protected cell"

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[118] *See generally* Andrew S. Rowen & William D. Torchiana, *supra* note 113, at 284.

[119] *See id.* at 285.

[120] *See* Bertil Lundqvist, *supra* note 7, at 810-811.

[121] For instance, in the United Kingdom Section 16 of Insurance Companies Act 1982 provides that: "An insurance company .... shall not carry on any activities, in the United Kingdom or elsewhere, otherwise than in connection with or for the purposes of its insurance business." *See* Michael Graham, *supra* note 108, at 93.

[122] For instance, The Cayman Islands (The Companies (Amendment) (Segregated Portfolio Companies) Law, 1998) and Guernsey (The Protected Cell Companies Ordinance 1997). A protected cell company, which is a modern derivative of the capital company, is a single legal entity comprising a number of separate cells. "The assets and liabilities of one portfolio or cell generally are insulted from the generally business and liabilities of the company and those relating to another portfolio or cell, and any assets not allocated to a specific portfolio or cell are considered to be general assets of the company". *See* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *supra* note 2, at 97. *See also* REINSURANCE PRACTICE AND THE LAW, *supra* note 5, at 14-4 (Issue No. 14-1, March 2000).

legislation in the United States[123].

Apart from regulatory issues relating to carrying on insurance business, the corporate structure of the SPR tends to be driven by the relevant regulatory system and tax regime because the SPR generally does not "involve any material financial opportunity to residual equity holders"[124]. Under this circumstance, the SPR should avoid being treated as "engaged in a trade or business" in some highly regulated jurisdictions. Therefore, substantive negotiations over reinsurance contracts and other agreements relating to the formation of the SPR, the invested proceeds of the insurance-linked securities, and operating activities should be held outside these jurisdictions[125].

In addition to tax and regulatory reasons, the SPR should be operated independently from the ceding insurers in order to reduce actual or potential conflict of interests between the ceding insurers and the investors. Nevertheless, the structure of the SPR generally should be approved by the ceding insurers such as to the location of the SPR, the arrangements concerning the security of over fund raised by the reinsurance premium and the nature and structure of the insurance-linked securities[126]. In relation to investors' interest, arrangements, generally to be provided in a trust deed for investors, would include the following:

(1) Controls on creating security over the SPR's assets or SPR incurring debt or giving credit by the SPR;

(2) Restrictions on the acceptance of risks and the manner of settlement of claims;

(3) Provision of appropriate information to the investors by the SPR;

(4) Regarding the reinsurance contracts with the ceding insurers, ensured by the SPR that the reinsurance arrangements will not be replaced or amended and the

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[123] In the United States, Illinois and Rhode Island have already introduced their own protected cell legislation. *See* Garry Booth, *Convergence and the Future*, in INSURANCE RISK SECURITIES- A GUIDE FOR ISSUERS AND INVESTORS 99, at 104 (Garry Booth & Charles J. Allard Jr., ed., 1999).

[124] *See* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *supra* note 2, at 98.

[125] *See generally* Bertil Lundqvist, *supra* note 7, at 811. *See also* Andrew S. Rowen & William D. Torchiana, *id.* at 296-299.

[126] *See* Michael Graham, *supra* note 108, at 91-92.

corporate structure of the SPR will not be merged, consolidated or changed[127].

Furthermore, the applicable tax regime will substantially affect the structure of the SPR. Tax liability for the SPR mainly exists in relation to any profit it makes. For instance, in the United States, the SPR would be subject to a relative high income tax, which would substantially reduce the return to investors and would increase the transaction costs on the insurance securitisation if they were found to be engaged in a "trade or business" within the United States[128]. Alternatively, an SPR often intends to treat itself as a "passive foreign investment company" (PFICs) because the insurance-linked securities may be treated as "equity interest" for U. S. federal income tax purposes. In relation to this election, "investors in the bonds agree to the treatment of the SPRs as PFICs and covenant to take no action inconsistent with that treatment"[129].

3. Reinsurance contract and SPR

As mentioned above, the main contractual relationship between SPR and the ceding insurer is based on the reinsurance contract transferring the ceding insurer's risk to SPR. The main motive of the ceding insurers in insurance securitisation transactions is to reduce its technical reserves by the amount of reinsurance contracts offered by the SPR. As a result, in some jurisdictions, an SPR is required to demonstrate its financial solvency or to provide appropriate collateral arrangements in order to meet the requirements of domestic insurance regulation relating to reinsurance arrangements[130].

With respect to the financial solvency of an SPR, it would affect the solvency credit that an insurer could take for a reinsurance contract in some jurisdictions where the regulators prudentially monitor the financial condition of the SPR[131]. In this regard, it should be noted that the SPR often has no significant assets other than the proceeds of the issue of the insurance-linked securities. Thus, counter-party risk still

[127] *See generally id.* at 90-98.

[128] In this case, "the SPR would be subject to US income tax at a rate up to 35 %, and 30% branch profit tax, on their income computed without any reduction for interest on securities they issue, resulting in an effective U.S. federal income tax rate up to 54.5%". *See* Bertil Lundqvist, *supra* note 7, at 811.

[129] *See id.* at 811.

[130] In the United States, if an SPR is established in offshore and is not licensed or accredited as an insurance company or reinsurer, "a reinsurance trust usually is required to enable the ceding insurer to take "credit" for the reinsurance provided by the SPR." In other words, a reinsurance trust is to enable the ceding insurer to reduce its technical reserve for the reinsurance provided by the SPR. *See* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *supra* note 2, at 98-99. *See also* NAIC, *Section 2D of the NAIC Credit for Reinsurance Model Law.*

remains in the reinsurance contract and may arise from the SPR being unable to meet its obligation, particularly when the arrangements cover a relatively long period of time. As a result of this risk, the ceding insurers, investors and regulators should pay careful attention to ensure that the proceeds of the issue and the premiums paid will be sufficient to meet the SPR's obligation arising not only under the reinsurance contracts but also under the issue of insurance-linked securities. In practice, the ceding insurers may require the SPR to invest conservatively and to provide collateral arrangements such as the deposit of collateral, a letter of credit[132]. In relation to collateral arrangements such as through a "reinsurance trust" in the United States, these arrangements usually are required to help provide financial security to the ceding insurer and should invest and be operated for the benefit of the ceding insurers[133].

E. Recent Regulatory Development relating to Insurance Securitisation Transactions

The need to create some forms of effective regulatory mechanism has been confirmed by the continued growth in the use and increased complexity of insurance securitisation transactions in international insurance markets. While the development of insurance transactions raises a large number of regulatory and legal issues, the most important challenge is the facilitation of such an arrangement which ensuring that all of the securitisation transactions are subject to prudential supervision and regulation. Several attempts by regulatory authorities have been made to meet this challenge.

1. Illinois Insurance Exchange and NAIC Protected Cell Company Model Act

It has been estimated that from 1997 to 1998, approximately $2 billion in international insurance reinsurance capacity has been created through insurance securitisation transactions[134]. While most of these transactions took place in jurisdictions such as Barbados, Bermuda and the Cayman Islands[135], the National Association of Insurance Commissioners and insurance regulators in several states of the U.S. have launched

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[131] *See* Katherine Coates, Hilary Evenett & Cheryl Ronaldson, *supra* note 115, at 36.
[132] *See id.* at 35.
[133] *See* Michael P. Goldman, Michael J. Pinsel and Natalie Spadaccini Rosenberg, *supra* note 2, at 99.
[134] SWISS RE (New Market), *supra* note 93, at 3.
[135] *See* David Alberts, *Bringing Insurance Securitisation Onshore in the US*, REACTIONS, May 1999, at 46.

initiatives to create a regulatory framework to allow insurance transactions operated on-shore by adopting the "Protected Cell Company Model Act".

Before the creation of a similar regulatory framework in several states, the Illinois Department of Insurance had adopted its Regulation 27, filed by the Illinois Insurance Exchange (known as "Inex"), which allows property and casualty insurers to fund insurance liability through insurance securitisation. Consequently, the first state-regulated securitisation transaction, Kemper Insurance Companies/Inex, was completed in April 1999. In this securitisation transaction, Kemper Insurance Companies issued insurance-linked securities through an "Index syndicate" and obtained the coverage for Midwest earthquake catastrophes by funding a fully collateralised reinsurance arrangement.[136]

In general, a "protected cell" would be a custodial account established to hold and to invest protected cell assets from the protected cell company's general account. A protected cell account is segregated and insulated from the protected cell company's general assets and liabilities.

a. Illinois Protected Cell Legislation

The basic regulatory framework regarding protected cell legislation introduced by Illinois, namely Regulation 27, sub section C: limited syndicates, is as follows:

(1). Authorisation of insurance securitisation: A limited syndicate may participate in the securitisation of insurance and reinsurance risk ("insurance securitisation") as reinsurer, co-participant, investors or otherwise; provided, however, such limited syndicate shall engage in no other business during the period of time in which it participates in insurance transaction. A special purpose limited Syndicate that intends to participate in insurance transaction must receive the prior approval of the Board for each proposed transaction[137]. In determining whether to grant such approval, the Board shall consider the business plan describing the proposed insurance securitisation, the parties involved in this transaction and the impact on Exchange (Illinois Insurance Exchange)[138].

(2). Operation and investment: A limited syndicate may conduct or engage in

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[136] *See id.*
[137] *See* Garry Booth, *supra* note 82, at 104.
[138] *See id.* at 105.

any activities and enter into any agreements and transactions, as may be necessary or appropriate to effect insurance securitisation[139].

(3). The trust established to secure the financial condition of the SPLS: The Special Purpose Limited Syndicate shall establish a trust to secure the Special Purpose Limited Syndicate's maximum aggregate potential reinsurance or participation obligation to the syndicate or limited syndicate[140]. With respect to the trust, the trustee shall be a financial institution with one or more offices located in the State of Illinois. The assets deposited in the trust account shall consist of cash; or commercial paper with a certain rating (A1 or better) from specified rating agents such as Standard & Poor's Rating Services; or other assets to ensure the financial solvency of the Special Purpose Limited Syndicate[141]. The assets held in trust shall be for the benefit of the syndicate or limited syndicate and a secondary beneficiary of the trust may be the insured or ceding company. The trust agreement shall have those standard provision for such agreements as contemplated by Section 173.1 of the Illinois Insurance Code (215 ILCS 5/173.1) and Illinois Insurance Regulation 1104.70(50Ill. Adm. Code §1104.70). In addition, "such trust agreement shall provide for the return of assets by the trustee to the Special Purpose Limited Syndicate upon the receipt by the trustee of a certification[142]. In order to "satisfying the risk limitation, risk ratio and reserve provisions of these Regulations, the Act and applicable provisions of the Illinois Insurance Code, and in calculating risk-based capital and reserve, the retained risk of a Special Purpose Limited Syndicate shall be that amount of risk that is in excess of the assets held in the trust established to secure the Special Purpose Limited Syndicate's obligations to the syndicate or limited syndicate"[143].

(4). Reporting requirement: In order to assess the financial security of such a transaction, this legislation prescribed specified provisions addressing the reporting requirements. It should be noted that the financial statement can be simplified to an annual statement if the statement is certified by the Manager of the Special Purpose Limited Syndicate. This will significantly reduce the transaction costs.

It has been stated that "The periodic reporting requirements of Section 17 may

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139 *Id.* at 105.
140 *Id.* at 105.
141 *Id.* at 105-106.
142 *Id.* at 106.
143 *Id.* at 107.

be modified for a Special Purpose Limited Syndicate to permit substituting for an annual statement a simplified annual financial statement that is certified by the Manager of the Special Purpose Limited Syndicate, and to waive the requirements or quarterly statements, actuarial reports and certifications, and annual business plan"[144].

(5). Corporate Issue relating to acquisition of control or change in control: The acquisition by a person of voting securities shall not constitute an "acquisition of control" or "change in control" of the Special Purpose Limited Syndicate unless otherwise specified in the Director's approval of a proposed insurance transaction. This approval shall be deemed to be a determination by the Director that such control transaction will not result in an acquisition of control of the Special Purpose Limited Syndicate for purposes of Section 131.4 of the Illinois Insurance Code (215 ILCS 5/131.4)[145].

(6). Insurance contract issue: It is arguable that the investor of insurance-linked securities could be construed as carrying on insurance business in most jurisdictions. This legislation has been established to clarify the uncertainty that the purchaser of securities might be found as conducting insurance business, and to provide that the purchase of securities issued by a Special Purpose Limited Syndicate or any person controlling or holding a debt or equity interest in, dose not constitute the transaction of an insurance business. In this regard, the underwriters or selling agents involved in an insurance transaction would not be deemed to be conducting an insurance or reinsurance agency, brokerage, intermediary, advisory or consulting business, either[146].

b. NAIC Protected Cell Company Model Act

On September 21 1999, the NAIC Financial Condition Subcommittee adopted the Protected Cell Company Model Act. This act is designed to allow the insurers in the United States to create protected cells to issue insurance-linked securities and to fund insurance liability through insurance securitisation[147]. The main purpose of this Act is to bring insurance securitisation transactions back to the United States because the

[144] *Id.* at 107.
[145] *Id.* at. 108.
[146] *Id.* at 108.
[147] "Our goal in developing this model was to create a regulatory framework to allow property and casualty insurers to create protected cells to fund insurance liability through insurance securitization." NAIC President and Connecticut Insurance Commissioner Reider said, from Mealey's Litigation Reports: Insurance Insolvency, 11 No. 9 Mealey's Litig. Rep.: Insolvency 23, 6 October 1999.

securitisation business is often placed through offshore transactions. Protected cell means an identified pool of assets and liabilities of a protected cell company segregated and insulated from the protected cell company's general assets and liabilities[148]. In addition, the protected cell account is established to segregate the protected cell assets of one protected cell from the protected cell assets of other protected cells and from the assets of the protected cell company's general account.[149]

The Model Act provides as follows:

(1). Establishment of Protected Cells: A protected cell company, which intends to establish one or more protected cells, must obtain the prior approval of the commissioner[150]. All attributions of assets and liabilities between a protected cell and the general account are to be in accordance with the plan of operation approved by the Insurance Commissioner[151]. "The creation of a protected cell does not create, in respect of that protected cell, a legal person separate from the protected cell company. Amounts attributed to a protected cell under this Act, including assets transferred to a protected cell account, are owned by the protected cell company and the protected cell company may not be, nor hold itself out to be, a trustee with respect to those protected cell assets of that protected cell account".[152]

(2). Use and Operation of Protected Cells: With respect to the liabilities of the protected cell, the assets of a protected cell may not be charged with liabilities arising from any other business the protected cell company may conduct[153]. In relation to the liabilities of the issuance of insurance-linked securities, the contracts or other documentation effecting the transaction shall contain provisions identifying the protected cell to which the transaction will be attributed[154]. As a result of separation from the protected cell company's general account, the protected cell shall not "be assessed by or otherwise be required to contribute to any guaranty fund or guaranty association"[155].

(3). Reach of Creditors and Other Claimants: Protected cell assets shall only

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[148] *See* N.A.I.C., *Protected Cell Company Model Act,* §3G, in NAIC MODEL LAWS, REGULATIONS AND GUIDELINES VOL.III, 290-2 (2000).
[149] *See id. Protected Cell Company Model Act* §3.H, at 290-2.
[150] *Protected Cell Company Model Act* §4.A, *id.* at 290-3.
[151] *Protected Cell Company Model Act* §4.B, *id.* at 290-3.
[152] *Protected Cell Company Model Act* §4.C, *id.* at 290-3.
[153] *Protected Cell Company Model Act* §5.A, *id.* at 290-4.
[154] *Protected Cell Company Model Act* §5.E, *id.* at 290-5.

be available to the creditors of the protected cell company that are creditors who are entitled, in conformity with the provisions of this Act, to have recourse to the protected cell assets attributable to that protected cell. It will be absolutely protected and separated from the creditors of the protected company that are not creditors of that protected cell. The creditors of that protected cell are not to be entitled to have recourse against the protected cell assets of other protected cells or the assets of the protected cell company's general account[156].

(4). Conservation, Rehabilitation or Liquidation of Protected Cell Companies: The receiver is bound to deal with the protected cell company's assets and liabilities, including protected cell assets and protected cell liabilities, notwithstanding any contrary provision in the insurance code or relevant regulations of this state upon any order of conservation, rehabilitation or liquidation of a protected cell company. The amount recoverable by the receiver is not reduced or diminished as a result of the entry of an order of conservation, rehabilitation or liquidation with respect to the protected cell company[157].

(5). Insurance Contract Issue: A protected cell company insurance securitisation is not to be deemed to be an insurance or reinsurance contract. An investor in a protected cell company insurance securitisation shall not be deemed to be carrying on insurance or reinsurance business. Consequently, the underwriters or agents involved in this transaction are not to be deemed to be conducting an insurance or reinsurance agency, brokerage, intermediary, advisory or consulting business[158].

The Protected Cell Company Model Act has been adopted in whole or amended form by several states including Illinois[159], Iowa[160], Rhode Island[161], South Carolina[162] and Vermont[163].

2. Bermuda's Insurance Amendment Act 1998

As mentioned above, in order to take advantage of the reduced level of regulatory

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155 *Protected Cell Company Model Act* §6.D., *id.* at 290-6.
156 *Protected Cell Company Model Act* §6.A., *id.* at 290-5, 290-6.
157 *Protected Cell Company Model Act* §7.A., *id.* at 290-6.
158 *Protected Cell Company Model Act* §8., *id.* at 290-7.
159 215 ILL. Comp. Stat. §§ 5/179A-1 to 5/179A-40 (1999).
160 IOWA Code §§ 521 G. 1 to 521G. 10 (2000).
161 R. I. GEN.LAWS §§ 27-64-1 to 27-64-12 (1999).
162 S.C. Code ANN. §§ 38-10-10 to 38-10-80 (2000).
163 V. T. STAT. ANN. tit. 8 § 6021 (1999) (captives only).

scrutiny and to relieve the tax burden, SPRs historically have been established in Bermuda or the Cayman Islands, which subject them to minimum net worth, auditing reporting requirements and to a favourable tax regime[164]. Bermuda, in which many popular investment vehicles are established in place of traditional reinsurance, has enacted section 57 A of the Bermuda Insurance Act 1978, as amended by the Insurance Amendment 1998 (Act No. 8 of 1998). This amendment has been described as providing a mechanism[165] to clarify that certain popular investment vehicles established in Bermuda in place of traditional reinsurance are exempt from "both the regulatory constraints on conducting insurance business and common law and statutory prohibitions on wagering contracts[166]". These insurance-linked bonds or securitisation arrangements may now be obtained through an application under section 57A of the Insurance Act 1978 for prospective or retrospective approval[167] of a contract as a designated investment contract. This amendment (section 57 A(1)(a) of the Insurance Act 1978) provides the definition of the designated investment contract as follows:

"The designated investment contract" means-

(a) any contract (including, but not limited to, any option contract, futures contract, swap contract, derivative contract, contract for differences or security) the purpose of which is to secure a profit or avoid a loss-

(i) by reference to fluctuations in the value or price of property of any description, or in an index, or other factor, specified for that purpose in the contract, or

(ii) in relation to which the Minister has given a direction under section (2).....[168]

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[164] *See* Bertil Lundqvist, *supra* note 7, at 810.

[165] "Uncertainty as to the legal standing of certain contracts under Bermuda law can adversely affect the ability of companies to raise capital for securitization deals. For example, linking an investment contract such as a bond to insurance results raises questions about its legal classification. This is important where capital is coming from institutional investors who want to know whether they will be deemed to be conducting business as insurers under Bermuda law". *See* Kymn Astwood, Minister of Finance, Press Release, (February 5, 1998).

[166] E. Massock, C. Scales, J. Abramson, J. Irving, M. C. Veed, G. Leal, R. J. Cata, A. Borrell, I. Kawaley, and L. Savitt, *supra* note 110, at 536-537.

[167] *See* section 78A(3)(a) of the Bermuda Insurance Act 1978.

[168] 57 A of the Bermuda Insurance Act 1978,as amended by the Insurance Amendment Act 1998(operative date 23 March 1998) provides that

" (1) For the purposes of this section-

If an insurance securitisation has been approved as a designated "investment contract", the contract will not be treated as an "insurance contract". "No party to the instrument can seek to argue that the transaction is contrary to public policy and void as a wagering contract of official sanction for it has been received, albeit in an insurance contract"[169].

F. Summary Observation: Implication of Reinsurance Regulation on the Securitisation of Insurance

While the appropriate regulatory regimes relating to the securitisation of insurance risks are being developed to facilitate such transactions, the reinsurance regulatory issues arising from these developed models are worth analysing for learning lessons that might be used in emerging economies. In this section, suggestions relating to reinsurance regulation concerning insurance securitisation will be provided which are based on the comparative study of these developed models. In addition, potential problems will be identified.

"Contract" includes investment or security, and any reference to "parties" in relation to an investment or security shall be taken to be a reference to its issuers and investors; and "designated investment contract" means-

(a) any contract (including, but not limited to, any option contract, futures contract, swap contract, derivative contract, contract for differences or security) the purpose of which is to secure a profit or avoid a loss-
  (i) by reference to fluctuations in the value or price of property of any description, or in an index, or other factor, specified for that purpose in the contract, or
  (ii) in relation to which the Minister has given a direction under section (2).

(2)The Minister may direct in writing that a contract falling within paragraph (a) of the definition of designated investment contract in subsection (1), which was submitted to him in draft together with-
(a) the fee of $1000, or such other fee as may be prescribed under the Government Fees Act 1965, and
(b) such other documents as the Minister may require, is a designated investment contract for the purposes of this section.
(3) A direction under this section-
(a) may be made with retroactive effect;
(b) may be subject to conditions which may be varied at any time, provided-
  (i) that the variation has been applied for, or is consented to by the parties to the contract in question; and
  (ii) that those parties undertake to notify such other persons as the Minister considers may be affected by the variation;
(c) is not a statutory instrument having legislative effect.
(4) Being a party to a designated investment contract shall not constitute carrying on insurance business, and a designated investment contract shall not constitute a contract of insurance, for any purposes.
(5) For the avoidance of doubt, a designated investment contract shall not constitute a bet for the purposes of the Betting Act 1975.
(6) The Minister may by order amend the definition of designated investment contract in subsection (1), if, after consulting the Insurance Advisory Committee, he considers it necessary to do so; and any such order shall be subject to the negative resolution procedure."

169 E. Massock, C. Scales, J. Abramson, J. Irving, M. C. Veed, G. Leal, R. J. Cata, A. Borrell, I. Kawaley, and L. Savitt, *supra* note 110, at 538.

1. Insurance contract issue and parametric trigger mechanism

As mentioned above, it is still arguable whether an investor for insurance-linked securities would or would not be deemed to be conducting insurance business that would be subject to relevant insurance regulation. To facilitate such a transaction, it has been suggested that insurance-linked securities based on industry-losses, on index or on a parametric trigger would distance the link between the payment to investors and the underlying loss suffered by the insurers. Such a distance, most likely, will reduce the legal uncertainty of the transaction because the payments to investors do not indemnify the ceding insurer's actual loss. From the viewpoint of efficiency, the parametric trigger mechanism not only improves the speed of settlement but also simplifies the modelling analysis for investors.

It should be noted, however, that the parametric trigger may increase the "basis risk" suffered by the ceding insurers and may raise other regulatory issues. First, would the basis risk suffered by the ceding have a significant impact on the financial solvency of the ceding insurers? While a main advantage of insurance securitisation is to reduce the credit risk caused by the financial insolvency of reinsurers through funding a trust, the basis risk arising from the mismatch between the ceding insurer's actual loss and payment of the investors should be prudentially reconsidered by the ceding insurers. Secondly, the issue relating to the adequacy of technical provisions would arise as the part of the technical reserve will have been reduced by the amount of the reinsurance transactions. For example, assume the parametric trigger is based on a "Richter earthquake magnitude" over 6. The earthquake occurs at a magnitude 5.5 and results in catastrophe loss to the ceding insurers. This basis risk will then cause a significant impact on the financial solvency of insurers because of inadequacy of loss reserves. Thirdly, if the reinsurance contracts are designed to be based on a relevant parametric trigger or other industry loss index, rather than on the ceding insurer's actual loss, it also increases the legal uncertainty to qualify as a "reinsurance contract". This will increase legal uncertainty and may give rise to the disputes relating to insurance interest and subject matter. In contrast, if the reinsurance contracts are based on the ceding insurer's actual loss rather than the parametric trigger or industry loss index, the basis risk will be suffered by the SPR. As the SPR does not involve any substantial financial operation, the basis risk will significantly weaken its financial condition and hence the trust funded by the ceding insurers and investors. This potential problem should be considered along with the possible impact on the ceding insurers. Therefore, the regulators and the ceding insurers should pay more attention to the adequacy of loss reserves and the creditworthiness of the SPR. Such circumstances take into account the possibility and severity of basis risk.

2. A Designated Investment Contract versus A Protected Cell Company

The main motive of developed models is to clarify that the insurance securitisation transaction is exempt from the regulatory constraints on conducting insurance business. However, the approaches to facilitate such a transaction and effectively to monitor relevant activities are significantly different.

With regard to Bermuda's Insurance Amendment Act 1988, this provision only prescribes the elements of certain transactions and the approval requirements. The specified provisions relating to insurance-linked securities still rely on the regulation or requirements set by the insurance regulatory authority. Due to the approval that can be obtained prospectively or retrospectively, potential problems can occur and legal uncertainty still can exists. Under section 57A of the Insurance Act 1978, approval for designated investment contracts can be obtained prospectively or retrospectively. This will lead to some insurance securitisation transactions, which have been effected but which have not obtained approval, failing to meet the requirement of the Minister. Therefore, approval with retrospective effect should be reconsidered due to this legal uncertainty. Furthermore, another issue is whether the payment of insurance securitisation transactions based on the ceding insurer's actual loss can constitute a designated investment contract rather than a reinsurance contract.

The Bermuda Insurance Act provides that the purpose of contracts that are to secure a profit or to avoid a loss "by reference to other factors specified for that purpose in the contracts" can be deemed a "designated investment contract". It is ambiguous to define that "other factor", might include the ceding insurer's loss. It should be noted that if the insurance-linked securities are based on the ceding insurer's actual loss, it will facilitate those who are not subject to relevant reinsurance regulation to carry on reinsurance activities by means of reinsurance securitisation transactions. The Minister should promulgate the relevant criteria to clarify this ambiguity.

In comparison with Bermuda's Insurance Amendment Act 1998, the Protected Cell Company Model Act approved by the NAIC is more prescriptive and provides specified guidance for securitisation transactions. Under the Protected Cell Company Model Act, a protected cell is created to be a custodial account established to hold and to invest assets from the proceeds of securities and reinsurance premium. The essential element of a protected cell is that the protected cell assets and liabilities is segregated and insulated from the protected cell company general assets and liabilities. Following such a basic structure, this Model Act also provides several specified provisions to supervise effectively these transactions. These includes establishment, use and operation of the protected cell, the segregated protected cell accounts, provisions to clarify the legal uncertainty relating to the insurance contract issue. The Illinois Protected Cell Legislation further prescribes the corporate issue relating to the acquisition of control or a change in control. The main purpose of this provision is to protect the investors' interest from being endangered by a change in control or other acquisition of control.

Unlike the Bermuda Insurance Amendment Act 1998, the approach developed by the US requires these securitisation transacions to obtain a prior approval from the Insurance Commissioners. This should enhance the legal certainty for those who intend to engage in these transactions. In order to support the financial condition of the SPRs, the Model Act provides provisions relating to the investment of protected cell assets.

While the possible methods to support the financial solvency of an SPR have been applied by limitations on the investment of protected cell assets, counter-party risk still may exists. In addition, the creditors of the SPR are not entitled to have recourse against the protected cell assets of a protected cell company's general account. Further, the protected cell account itself does not involve in any other substantial commercial operations. This would affect the recoverability of reinsurance payment and the acceptability of the insurance-linked securities. To deal with this shortcoming, an approach used is that credit support, similar to that applied in other securitisation transactions[170] can be proposed for enhancing the acceptability of insurance-linked securities and for reducing counter-party risk. In general, credit

[170] *See* JOSEPH J. NORTON, FINANCIAL SECTOR LAW REFORM IN EMERGING ECONOMIES 246-248 (2000).

support can be structured as either internal support or external support. External support is supported by the credit of other parties, such as financial institutions (*e.g*, a letter of credit), whereas internal support is dependent on the value of protected cell assets. However, due to the protected cell's limited assets, this will significantly increase the transaction costs by forming the internal support. As a result, the author suggested that it would be better to obtain credit support from external financial institutions.

Another issue that needs to be addressed the potential disputes relating to the conflicts of interests between the ceding insurers and the investors. This issue has not been addressed in the NAIC Protected Cell Company Model Act, whereas the Illinois Protected Cell Legislation prescribes specified provision relating to the approval regarding a change in control or acquisition.

In the insurance securitisation transaction, the ceding insurers may intend to exert some degree of control over their losses. On the other hand, the investors might be vulnerable to a change of control on the SPR as to loss settlement. While the insurance securitisation transactions are mainly influenced by the ceding insurers and the reinsurers, the investors would tend to protect their interest by arrangements including controls over the SPR as to creation of security, restrictions on the acceptance of risks, the settlement of risk, appropriate disclosure, and a change in control or acquisition. With regard to the settlement of loss, the degree of moral hazard of the ceding insurers might be reduced by applying a parametric trigger mechanism. This might offer investors greater certainty and objectivity. In addition, it is suggested that appropriate information regarding the risk of securities should be disclosed to the investors. This should provide greater transparency and certainty for the investors who intend to engage in and to assess these transactions. Therefore, appropriate regulation should provide requirements to ensure full material disclosure as the underlying transactions.

3. Developing a Regulatory Infrastructure for Insurance Securitisation

While the insurance securitisation transactions have created worldwide insurance and reinsurance capacity through the issuance of insurance-linked securities, the regulatory infrastructure to facilitate and effectively to supervise these transactions has only developed in some countries. This subsection will discuss a few of the more essential components of an appropriate regulatory infrastructure.

Countries wishing to facilitate securitisation of insurance risks should amend or abolish certain existing statutes or other laws that may prohibit any corporations or insurers from engaging in securitisation transactions. Alternatively, these countries may choose to pass specified legislation to allow these transactions such as has been done in Bermuda, Cayman Island, and several states in the US. As a result of legal ambiguity that the investors engaging in insurance securitisation transactions would be deemed as carrying on unauthorised insurance business, these countries should provide specified laws/regulations to define that the purchase of insurance-linked securities does not constitute the transaction of insurance business.

Learning from these developed models, the main element of the legal infrastructure for insurance securitisation is to develop suitable legislation to allow the creation of an SPR that can assume the insurance risks and that can issue insurance-linked securities. To reduce the transaction costs, some countries have developed the concept of the "protected cell" to allow these entities to engage in several transactions at the same time. Unlike other securitisation transactions where a SPV can be formed as a corporation, a trust, or as a limited partnership, the SPR usually is formed as a reinsurance company that is authorised to assume insurance risks and to issue insurance-linked securities. The collateral arrangements to ensure the financial solvency of the SPR should be established. In general, a trust is established along with certain restrictions on its investment activities. For example, the NAIC Protected Cell Company Model Act contains the provisions regarding the investment of the protected cell assets. In relation to the solvency and establishment of the SPR, basis risk should be considered, particularly in the case of the payment upon a parametric trigger, because this may endanger the financial solvency of the ceding insurer.

The relevant bankruptcy system should be amended to accommodate the concept of a "protected cell". The main feature of a protected cell is to shield a protected cell account's assets and liabilities from the credit risk of the reinsurers in the case of insolvency. By introducing this concept, the relevant bankruptcy system should ensure that the protected cell should not be affected by any order of conservation, rehabilitation or liquidation of a protected cell company. It should be noted, however, that the segregation of a protected cell, as a practical matter, would need external credit support to enhance the acceptability of the insurance-linked securities and to ensure the financial solvency of a protected cell.

In contrast to onshore securitisation transactions, the insurance supervisors should be aware of offshore insurance securitisation transactions. The insurance supervisors should be in a position to assess the appropriateness of reinsurance and related securitisation transaction. It is suggested that the assessment of these transactions should take into account the operation and the corporate structure of the SPR, along with the collateral arrangements relating to securitisation transactions and reinsurance contracts.

III. Concluding Remarks

At the expense of repetition but for the benefit of performing key observations, the author summarized his concluding observations below.

1. Traditional reinsurance deals with the consequences of insurance risks transferred from ceding insurers to reduce their loss reserves and to provide greater capacity to expand their business. Finite risk reinsurance, known as financial reinsurance, principally addresses the "timing risk" and other financial risks for providing more capital and more flexibility to finance the ceding insurers. As a result of the questionable reporting of these transactions as to financial condition of the ceding insurers, finite risk reinsurance poses potential difficulties for regulators and accountants throughout the world. Specific guidance regarding the accounting treatment for finite risk reinsurance has been mainly developed in the US and the UK. However, due to the complexity and diversify of finite risk reinsurance, an acceptable definition of finite risk reinsurance has not been developed under the relevant solvency regulations, and regulators often rely on the accounting principles to define the differences between conventional reinsurance and finite risk reinsurance. At the international level, the International Accounting Standards Committee (IASC) was set up in the early 1970s to formulate and to publish, in the public interest, accounting standards to be observed in the presentation of financial statements and to promote their world-wide acceptance and observation. The IASC has set up a Steering Committee that has issued a discussion paper on insurance accounting. Although the steering committee has not yet developed guidance on the level or type of risk transfer to be used as a core element of reinsurance, it is likely that global accounting

standards for the treatment of finite risk reinsurance will be developed in the future[171].

2. With regard to appropriate regulation governing finite risk reinsurance, it is suggested that basic criteria relating to risk transfer should be developed to enhance transparency under the relative regulation for insurers and reinsurers. With regard to risk transfer criteria, it would be appropriate that timing risk alone is sufficient to constitute a reinsurance because the timing risk arising from the uncertainty of liability payment for policyholders will significantly affect the capacity of the ceding insurers. This should provide more flexible and less stringent regulatory requirements for insurers who suffer the timing risk arising from the assumed insurance risks. Additionally, the issue relating to the "economic substance" of transactions should take into account the terms of contracts that may affect the loss payment from the reinsurers and the reinsurance premiums paid by ceding insurers. In addition to risk transfer criteria, regulators should be able to assess the creditworthiness and the financial solvency of reinsurers. Furthermore, the adequacy of loss reserves should be considered even though reinsurance transaction meets the risk transfer criteria. As the finite risk reinsurance may lead to inadequacy of loss reserves, it is important to develop methods to estimate the extra reserves and to analyse the possible effect of terms of contracts on the insurer's financial solvency.

3. Insurance securitisation transactions provide insurers with an alternative risk transfer mechanism. Although recent low reinsurance pricing have been the main obstacle for the growth of insurance securitisation, the potential scale of insurance securisation market remains substantial. Insurance securitisation grew out of a period of limited reinsurance capacity arising from several catastrophes, so it is likely that the same structure of risk transfer transactions is developed quickly into areas other than catastrophe risk, such as credit risk, general liability, political risk[172] and life insurance. As the regulators and credit rating agencies have become more involved in these transactions and have begun evaluating and monitoring these insurance-linked securities, the focus on the credibility of the securities has been increased. As a result of adequate disclosure and prudent supervision of these transactions, more investors should feel more comfortable in accepting these securities as investment instruments.

4. While the insurance securitisation transactions have created worldwide

[171] *See* Jonathan Miles & Diana Owen, *supra* note 46, at 23.
[172] *See* Bertil Lundqvist, *supra* note 7, at 813.

greater insurance/reinsurance capacity through the issuance of insurance-linked securities, the regulatory infrastructure to facilitate and effectively to supervise these transactions have only been developed in some countries. To facilitate such transactions, countries should amend or abolish certain existing statutes or other laws that may prohibit any corporations or insurers from engaging in securitisation transactions. As a result of legal ambiguity that the investors engaging in insurance securitisation transactions might be deemed as carrying on insurance business, these countries should provide specific laws to define that the purchase of insurance-linked securities does not constitute the transaction of an insurance business.

5. Learning from these developed models, the main element of the legal infrastructure for insurance securitisation is to develop suitable legislation to allow the SPR that can assume the insurance risk and issue insurance-linked securities. To reduce transaction costs, some countries have developed the concept of the "protected cell" to allow these entities to engage in several transactions at the same time. In addition to creating protected cells, "basis risk" should be considered, particularly in the case where parametric trigger is used because it may endanger the financial solvency of the ceding insurer.

6. The relevant bankruptcy system should be amended to accommodate the concept of a protected cell. The main feature of a protected cell is to shield a protected cell account's assets and liabilities from the credit risk of the reinsurers in the case of insolvency. By introducing this concept, the relevant bankruptcy system should ensure that the protected cell is not affected by any order of conservation, rehabilitation or liquidation of a protected cell company. To ensure the financial solvency of protected cell accounts, it is suggested that the segregation of a protected cell would need external credit support.

7. Last but not least, insurance supervisors should be aware of offshore insurance securitisation transactions. In this connection, insurance supervisors should be able to assess the appropriateness of reinsurance and the relevant securitisation transaction. It is suggested that the assessment of these transactions should take into account the operation of and the corporate structure of SPR, and the collateral arrangements relating to the securitisation transactions and reinsurance contracts.

Chapter Five

Reinsurance Regulation Reform in Emerging Markets: Suggestions for Taiwanese Reinsurance Regulation Reform and the Broader Relevance

As set out in Chapter One, over the past two decades, the international insurance markets have experienced liberalization of reinsurance trade. However, emerging markets may encounter difficulties in reaching a critical balance between the creditworthiness/security (i.e., the creditworthiness and financial viability) of reinsurers and the availability of reinsurance. In searching for an appropriate regulatory approach to ensure financial stability with facilitating the diversification of insurance risks, developing countries might tend wholesale and uncritically to transplant aspects of the leading regulatory models of developed countries into their domestic regulatory reform or to adopt the supervisory principles established by international organizations such as International Association of Insurance Supervisors (IAIS). Although the supervisory principles developed by international institutions and sophisticated regulatory models adopted by some developed countries can be used as "guidelines" for the development of reinsurance regulation in emerging markets, the "*en masse*"application of these principles does not necessarily achieve an optimal outcome for these countries, if it does not take into account the pre-existing regulatory and legal environment and market characteristics.

In this Chapter, the Taiwanese insurance market will be used as a "case study" for identifying the potential problems in and providing suggestions for developing an appropriate regulatory system relating to reinsurance in emerging market. As set out in Chapter One, the Taiwanese insurance market relies on the international reinsurance market to extend its limited capital capacity to underwrite insurance risks and to stabilize the development of its domestic economy. Due to lack of reinsurers in Taiwan, the main issue relating to reinsurance regulation is to establish an appropriate regulatory regime to maintain the financial solvency of primary insurers. It should be noted, however, that some developed regulatory models implemented in the developed countries might not be appropriate for the emerging markets with a shortage of reinsurance. Based on a careful, analytical and practical scrutiny and taking into account the particular regulatory environment and market characteristics, suggestions will be provided as to potential solutions for the regulatory reform in the

Taiwanese reinsurance sector. This will be followed by recommendations concerning the fundamentals of reinsurance regulation reform in emerging markets more generally, through a comparative study on the Taiwanese reinsurance regulation reform.

I. Financial Regulation Reform and Reinsurance

Following the recent global trends of liberalization of financial services, the Taiwanese government began in the early 1990s to revise its laws and regulations to facilitate financial market access for greater international competition. As a result of the governmental policies to open up the financial markets, financial institutions in Taiwan increase dramatically[1] and these markets became "overcrowded"[2]. Due to the lack of innovative financial products, the financial institutions in Taiwan tended to engage in a fierce price war in the traditional markets[3]. In addition to fierce competition, the Asia Financial Crisis began to influence the stability of financial markets in Taiwan[4].

In order to cope with the dramatically changes in the global financial market and to follow the international trends of harmonization or convergence of financial market supervision, the Taiwanese government has been updating the legal and regulatory frameworks to facilitate financial restructuring[5]. In terms of recent regulatory reforms in Taiwan, there are several aspects of significance for present

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[1] With regard to bank sector in Taiwan, the number of the banks increases rapidly from 24 banks with 953 branches to 53 banks with 2690 branches. As for the securities market, the number of securities firms rose from 28 firms in 1988 to 196 in 1999. In the insurance market, the number of insurance companies has expanded from 45 insurance companies before 1992 to 62 insurance companies in 2000. See In-jaw Lai, Challenges of Financial Reforms, the speech delivered at the 2001 Economic and Financial Summit, 18 January, 2001, Taipei International Convention Center, Taipei, Taiwan, Republic of China, http://www.icbc.com.tw/chinese/news/news06/news32001/news32001.htm., visiting time: 06/01/2002.

[2] There are 53 commercial banks and 362 primary financial institutions with a population of 23 million.

[3] See In-jaw Lai, Challenges of Financial Reforms, the speech delivered at the 2001 Economic and Financial Summit, 18 January, 2001, Taipei International Convention Center, Taipei, Taiwan, Republic of China, http://www.icbc.com.tw/chinese/news/news06/news32001/news32001.htm., visiting time: 06/01/2002.

[4] Prior to the 1997 Asia Financial Crisis, the average Non-performing Loan ratio was only 4.18%. However, the NPL ratio rose up to 6.2 % at the end of December 1999. See Ching-Chang Yen, Recent Financial and Fiscal Developments in the Republic of China, the speech delivered at the US-ROC Business Council Board Meeting in Washington, D. C., United States on May 14, 2001. http://www.icbc.com.tw/chinese/news/news06/news323/news32301.htm, visiting time: 06/01/2002.

[5] Prior to the 1997 Asia Financial Crisis, the average Non-performing Loan ratio was only 4.18%. However, the NPL ratio rose up to 6.2 % at the end of December 1999. See Ching-Chang Yen, Recent Financial and Fiscal Developments in the Republic of China, the speech delivered at the US-ROC Business Council Board Meeting in Washington, D. C., United States on May 14, 2001. http://www.icbc.com.tw/chinese/news/news06/news323/news32301.htm, visiting time: 06/01/2002.

purposes: (1) liberalization of investment of banks in securities, insurance and other financial services[6]; (2) implementation of a Financial Holding Company Act to facilitate the cross-sector financial services and control the relevant risks[7]; (3) establishment of financial assets management companies to reduce non-performing loans in the banking sector; (4) the enactment of the Merger Law of Financial Institutions to allow the restructuring the financial market[8]; (5) establishment of the Financial Supervision and Management Committee as an financial supervisory agency to supervise and monitor the financial institutions efficiently[9]; and (6)

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[6] The Amended Banking Law was enacted in November 2000. With regard to liberalisation of investment by banks, it has dismantled the investment restriction imposed on the deposit banks. < http://www.boma.gov.tw/law/banklaw.htm>, visiting time:02/01/2002.

[7] In order to facilitate the cross-sector financial services, the enactment of the Financial Holding Company Law 2001 (hereinafter FHCL) allow the financial holding companies to be established and own the other financial institutions as subsidiaries. After the implementation of FHCL on 9 July 2001, there are several successful applications for establishment of financial holding companies such as Taiwan's First Commercial Bank acquiring Taisec Securities Inc., and Mingtai Fire & Marine Inc. Co., as well as five farmers' and fishermen's credit cooperatives. The law encourages the integration of financial services, the diversification of operational risks, and to enlarge the economic scale to encounter the fierce competition following with Taiwan's accession into WTO. See Chiu Yueh-wen, New Financial Holding Company Law, in Taipei Journal November 2001, http://publish.gio.gov.tw/FCJ/past/01110232.html, visiting time: 09/01/2002. However, it is questionable whether such a new legal infrastructure would benefit the Taiwanese economy. Although it provides an opportunity to allow the financial institutions to merger the other sector financial institutions, the transaction costs associated with the establishment of a holding company may deter the advantages from the cross-sector operations. For discussions about financial holding companies and universal banks, *see generally* Jennifer Manvel Jeannot, "An International Perspective on Domestic Banking Reform: Could the European Union's Second Banking Directive Revolutionize the Way in the United States Regulations its Own Financial Services Industry?", in American University International Law Review Fall 1999. Also see Mitchell S. Eitel, William D. Torchiana & Donald J. Toumey, "Gramm-Leach-Bliley Act Provisions of Particular Interest to Insurers and Banks", in After the Gramm-Leach-Bliley Act-A Road Map for Banks, Securities Firms and Investment Managers, Practising Law Institute-Corporate Law and Practice Course Handbook Series PLI Order No. B0-00QT, March 2000. George S. Zavvos, "Banking Integration and 1992: Legal Issues and Policy Implications", Harvard International Law Journal, Spring, 1990.

[8] It has been estimated that NPLs in Taiwanese banks reached their highest level in recent years-officially 5.49 %. In addition to the ratio in Taiwanese banks, NPLs of the most trouble financial institutions 350 fishermen's and farmer's credit unions may reach as high as 50%. As a result, the government enacts the Merger Law of Financial Institutions to create asset management companies that could purchase NPLs and liquidate collateralized assets. As a result of over-crowd financial institutions in Taiwan, the competition among institutions might bail out the low performance of institutions. To reduce the systemic risk and its impact on the public, the government encourages the merger of financial institutions to restructure the financial market and maintain the stability by passing the Merger Law of Financial Institutions. See "Financial Reform in Taiwan Gets a Boost", in Asia Pacific Bulletin-A Weekly Analysis of Breaking Issues in Asia Pacific, May 24, 2001, Asia Pacific Bulletin 8, www.asiapacific.ca, visiting time: 08/01/2002.

[9] Learning from the Financial Services Authority in UK, the Draft Financial Supervision and Management Committee Organization Law has been submitted by the Executive Yuan to the Legislative Yuan in March 2001. While the enactment of the Financial Holding Company Law allows the cross-sector financial services, the functional regulation system is in need to supervise the financial holding companies more efficiently. However, unlike the Financial Services Authority, the fund of FSMC is monitored by the Legislative Yuan. In this regard, the independence of such an institution might be impeded.

development of the Trust Enterprises Law and Securitization of Financial Assets Act[10] to liquidate collateralized assets, to provide the investors with innovative investment instruments and to minimize the risks arising from non-performance loans.

In the area of the insurance sector, the recent regulatory reform generally has focused on the liberalization of the investment, of insurance undertakings, risk-based capital requirements, corporate governance, internal control, financial reporting requirements relating to actuaries and external auditors, restructure of the "guarantee fund" to enhance of the protection of the policyholders in the event of insolvent insurers, revision of the current "technical provision" requirements, provisions of earthquake insurance for home owners, and investment-linked insurance[11]. In relation to reinsurance, the most important components of the recent Taiwanese regulatory reform are the new Rules of Capital Adequacy for Insurance Enterprises published on 20 December 2001 and to be implemented in September 2003[12]. Learning from the U.S. NAIC Risk-based Capital for Insurers Model Law, these Rules address the risk-based approach for evaluating the financial solvency of insurers. As the insurance business risks an insurance undertaking assumes will increase with the growth of business, the traditional fixed-sum capital requirements can not adequately respond to the various risks inherent in the business. In order to maintain an insurer's capital adequacy to encounter the internal and external risks (e.g., business risk and market risks), risk-based capital (hereinafter as RBC) requirement has been enacted to correct the drawbacks of fix sum capital requirement.

Risk-based capital computations specify a minimum amount of capital based on the company's risks. In accordance with the new rules, the risks of life insurers are divided into (1) asset risk, (2) insurance risk; (3) interest risk; and (4) other risk[13]. For property insurers, the risks are categorized into the following risks (1) asset risk; (2)

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[10] The Trust Law and Trust Enterprises Law have been implemented in 1996 and 2000. As NPLs endangered the stability of Taiwanese financial market, the Executive Yuan proposed the draft Securitization of Financial Asset Act to facilitate the asset securitisation providing a means to assess the capital market and improve the liquidity. After the implementation of the Securitization of Financial Asset Act, the main stream of products will include house mortgage loans, automobile loans and credit card loans.

[11] These have been published in the official website of the Department of Insurance, Ministry of Finance, Taiwan, ROC. Prospectus, Department of Insurance, Ministry of Finance, in http://www.insurance.gov.tw/watch/watch4.asp, visiting time:02/01/2002.

[12] In accordance with the section 143-4 of the Insurance Law amended in June 2001, the Rules of Capital Adequacy for Insurance Enterprises (20/Dec./2001) was published. The Rules of Capital Adequacy for Insurance Enterprises, Tai-Tsai-Bao, No. 0900751413.(20/Dec./2001)

[13] Section 3 (1) of the Rules of Capital Adequacy for Insurance Enterprises, Tai-Tsai-Bao, No.

credit risk; (3) underwriting risk; (4) asset-liability matching risk; and (5) other risks[14]. These risks are combined in accordance with a formula to determine the total RBC amount. Consequently, the total RBC amount is adjusted for a correlation between risks and additional risks in certain types of risk categories such as "investments". The resulting adjusted total RBC amount is compared with the "Surplus Capital" (known as Total Adjusted Capital in the U.S.), which consists of company capital, surplus and special reserve determined by the relevant statutory accounting principles[15]. If the value of its ratio between the two components falls below the required level, this may trigger governmental intervention in accordance with Section 149 (1), (2) and (3) of Insurance Law amended in 2000. For instance, the Department of Insurance required the insurance undertaking to submit a comprehensive financial plan to correct the financial problems or control on the operation of the insurance undertaking[16].

Under this new Taiwanese regulatory system, the adequacy and the security of reinsurance arrangements of a primary insurer can be ensured if the relevant regulatory approach has been considered. As a result, a possible regulatory approach concerning the creditworthiness/security of reinsurance will be suggested so as to take into account the related solvency regulation system.

II. Issues of Reinsurance Arrangements of Primary Insurers in Taiwan

Under the new Taiwanese solvency regulatory regime based on risk-based capital, insurance undertakings should increase their paid-in capital commensurate with the growth in their insurance business to respond to the risks associated with the operation of their insurance business. Under such a dynamic capital mechanism, the regulation concerning the "security" (*i.e.,* creditworthiness and financial viability) of reinsurance will be suggested as follows.

0900751413, (20/Dec./2001), Taiwan, ROC.

[14] Section 3 (2) of the Rules of Capital Adequacy for Insurance Enterprises, Tai-Tsai-Bao, No. 0900751413, (20/Dec./2001), Taiwan, ROC.

[15] Section 143-4, Insurance Law and Section 2, 3 of the Rules of Capital Adequacy for Insurance Enterprises, Tai-Tsai-Bao, No. 0900751413, (20/Dec./2001), Taiwan, ROC. The relevant accounting principles are generally contained in the Principles for the Annual Business Examination Report of Life Insurance Undertakings and the Principles for the Annual Business Examination Report of Property Insurance Undertakings, Tai-Tsai-Bao, No. 0900751404.

[16] Section 143-4 (3), Insurance Law (amended in June 2001) Taiwan, ROC

A. The Security of Reinsurance Should Be Considered In the Framework of the Risk-Based Capital Solvency Regulation

In terms of risk-based capital approach, the security of reinsurance can be structured into the calculation of technical "provisions" affecting the "Surplus Capital" account. The credit given to reduce the required technical provisions and increase in admissible assets should only be allowed if the reinsurance arrangements of insurance undertakings meet the criteria regarding the recoverability and creditworthiness/security of reinsurance. If the reinsurance arrangement fails to meet the criteria, the technical provisions cannot be reduced and their liabilities remain the same as before the purchase of reinsurance. As a result, it may affect the amount of the "Surplus Capital", representing the excess of admissible assets over liabilities, and then may reduce the value of the ratio between the Risk-based Capital and the "Surplus Capital". Consequently, this may trigger governmental intervention to revise the relevant reinsurance arrangements or increase their paid-in capital to maintain the required capital adequacy level, if the resulting value of the ratio falls below the required level.

B. The Establishment of the Criteria Regarding the Security of Reinsurance

The search for an appropriate regulatory approach concerning the creditworthiness/security of reinsurance should take into account the particular market characteristics and pre-existing legal environments. In comparing the possible regulatory approaches among the developed countries and as to emerging markets, the collateralisation of reinsurance ceding to unauthorized reinsurers in the U.S. can not only significantly reduce the possibility of credit risk arising from insolvency of reinsurers but also can maintain the competitive advantages of domestic reinsurers[17]. It should be noted, however, that the transaction costs associated with the requirements relating to the collateral and the related trust fund may impede the diversification of insurance risks particular in countries with a shortage of capital capacity to assume the insured risk. As a result, the regulation of insurers' reinsurance arrangements should emphasis on the accurate evaluation of reinsurers' financial condition rather than merely the domicile of reinsurers (e.g., the US model). For

[17] For details, see Chapter 2.

example, it seems that the Mexican approach utilising the analysis made by the rating agencies may be an appropriate model for emerging markets with limited expertise. But, even with that approach, there may be some flaws if other external and internal factors have not been considered, such as political risk in the location of the reinsurers, the fitness and propriety of management, and the foreign jurisdictions relating to the relevant regulations and the accounting principles. Therefore, the "rating results" should not be used as the sole "yardstick" to evaluate the creditworthiness/security of reinsurers.

C. Requirements Regarding Good Corporate Governance and Internal Control Should Include the Reinsurance Arrangements

As the failure of reinsurance may result from poor management, good corporate governance is essential to promote sound risk management of primary insurers. In relation to reinsurance arrangements of primary insurers, the relevant criteria concerning the adequacy of reinsurance and the recoverability of reinsurance should be structured into an appropriate framework of internal controls. Although the importance of corporate governance and internal controls has been addressed in the recent Taiwanese regulatory reform[18], the details regarding reinsurance arrangements have not been provided. As a result, it is suggested that the requirements relating to internal control should establish an evaluation procedure to assess creditworthiness/security of reinsurers and to develop effective means to measure and to monitor the reinsurance contracts as well as the adequacy of reinsurance coverage. In addition, the collection of reinsurance should be considered in the framework of internal control. Such a procedure should provide for the actual process of reinsurance claims, should identify the collection problems (e.g., legal disputes, financial condition of the reinsurers, jurisdiction), and should establish the approaches to achieve collection. In sum, the private rating agencies can be considered as an important component of the overall evaluation procedure for assessing the creditworthiness/security of reinsurers in order to reduce the credit risk of reinsurance.

III. Issues relating to Reinsurance Intermediaries

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[18] Section 148-3 of the Insurance Law (amended in 2001). The insurance supervisors in accordance with this new section shall issue the relevant requirements regarding internal control. On 20 December 2001, the Insurance Department of Ministry of Finance issued its Rules for the Implementation of Internal Control and Audit of Insurance Undertakings, Tai-Tsai-Bao, no. 0900751422.

In Taiwan, insurers often rely on a reinsurance intermediary to cede insurance risks or to accept reinsurance business. Furthermore, transactions between insurers and the reinsurance intermediary are generally on a cross-border basis. Under these circumstances, the implementation of regulation of reinsurance intermediaries is complicated. In addition to the difficulty of implementation of intermediary regulation, it should be noted that the enactment of strict regulation might impede the freedom of reinsurance transactions and the diversification of insurance risks. Learning from those developed regulatory models in the US, European Union and the UK, several fundamental aspects should be considered when Taiwan intends to adopt these models.

With regard to the insurance regulation regime in Taiwan, the main component of the current regulatory regime is the Regulation Governing the Administration of Insurance Agencies, Brokers and Surveyors[19]. According to Section 163 of the Insurance Law, insurance intermediaries are required to obtain the license approved by the Ministry of Finance. The requirements relating to the criteria and capital adequacy are described in the aforesaid Regulation.

Similar to the system of the UK, the Taiwanese system perceives that the fitness and the propriety of management have been considered in the licensing procedure including the matter of required professional qualifications[20]. However, there are no differences between the insurance intermediary who deals with private consumers and the reinsurance intermediary who transacts with the commercial consumers. In other words, regardless of their natures of business, the insurance and reinsurance intermediary should be subject to the same criteria. In this regard, it is argued[21], however, that the same criteria might not be sufficient to ensure the expertise of an reinsurance intermediary to carry on the reinsurance business especially ceding business to foreign reinsurers.

In relation to capital adequacy, the minimum statutory paid-in capital for establishment of an insurance intermediary in NT$ 2 million (around UK £ 40,000 at 2001 exchange rate) is required. In addition to the minimum statutory paid-in capital,

[19] Regulation Governing the Administration of Insurance Agents, Brokers and Surveyors (Sep. 1997).
[20] See Section 6 and 7 of Regulation Governing the Administration of Insurance Agents, Brokers and Surveyors (Sep. 1997).
[21] Chia-Yi Young, Research on Regulation of Reinsurance, Dissertation for Mater Degree in National Chengchi University, Taiwan, (June 1998), p. 135.

an insurance intermediary is required to hold professional indemnity insurance or some other comparable guarantee[22]. However, there is no investment regulation governing the financial solvency of insurance intermediary. Due to lack of limitation on the investment of insurance premiums and claims, it is argued that the insurance intermediary might not be able to make appropriate investment arrangements and to maintain a suitable level of liquidity to ensure their financial obligations relating to insurance monies.

With respect to market conduct regulation concerning the insurance intermediary, the Taiwanese regulation generally focuses on the market conduct of the insurance intermediary rather than that of the reinsurance intermediary[23]. Due to the difference in the nature of their respective business, insurance intermediary and reinsurance intermediary will have significant differences in their market conduct for exercising "reasonable care and skill" in the business. However, there is no such distinction made between an insurance and reinsurance intermediary in the current regulatory regime. It is argued that the same principles applying to their different intermediaries might lead to the distortion of reinsurance business.

Learning from the UK and US model, but taking into the market characteristics and legal environments in Taiwan, the following possible suggestions are submitted:

A. A Distinction between Insurance and Reinsurance Intermediary Should Be Considered

Due to the differences of the business nature between an insurance intermediary and reinsurance intermediary, it is argued that the requirements based on the insurance intermediary who deals with the private consumers may not be appropriate to apply in the reinsurance intermediary who transacts with the commercial consumers-insurance undertakings. As a result, it is suggested that a distinction should be considered in the regulatory framework. For instance, the relevant criteria concerning the fitness and propriety of management should contain the specific requirements of the expertise of a reinsurance intermediary and should take account of any special professional qualification. In addition, the principles concerning the market conduct of reinsurance

[22] Section 17 (1) of Regulation Governing the Administration of Insurance Agents, Brokers and Surveyors (Sep. 1997).
[23] Section 36 of Regulation Governing the Administration of Insurance Agents, Brokers and Surveyors

intermediary should be amended to apply to the reinsurance intermediary context.

B. Market Conduct of Reinsurance Intermediary Should Be Considered As An Essential Part of Regulatory Regime

The market conduct of the reinsurance intermediary should be considered as the essential part of a viable regulatory regime. The overall regulation should ensure that the reinsurance intermediary exercises a "reasonable care and skill" in carrying on its business. As mentioned in Chapter 3, the approach adopted by the NAIC might interfere with the law of agency and thus impede the freedom of private contracting. The UK approach, which lays down fundamental principles and states several examples, seems more appropriate for other emerging markets to develop an appropriate regulatory regime. The reinsurance intermediary should be subject to minimum standards to ensure that it meets high standards of competence and integrity. These principles could ensure that the reinsurance intermediary exercises a reasonable care and skill in carrying on its business and that the monies received from premium and claims are held prudentially. In addition, these standards should address issues such as the avoidance of conflict of interests arising from dual agents, the avoidance of legal disputes of authority relating to sub-agency, timely and "best execution" of transactions, the right of the (re)insurers to terminate the arrangements, and the duty of the reinsurance intermediary to maintain all relevant documents.

C. Insurance Monies from Premium and Claims should be Maintain in a Separated Account

In order to maintain a suitable level of liquidity to meet the financial obligation of the reinsurance intermediary, the insurance monies held by the reinsurance intermediary should be maintained in a specific account that should be segregated from the general assets of the reinsurance intermediary. Further, the reinsurance intermediary should be subject to minimum standards to ensure that these insurance funds will be held and invested in connection with specified purposes stated in the relevant regulations (such as UK GISC Rules in the Chapter Three). In addition, it is important to assure that in the event of bankruptcy of intermediary these accounts are not be used to reimburse other creditors.

(Sep. 1997).

D. Disclosure Requirements relating to Fronting Arrangement

It is a common practice that insurers in emerging markets accept or assume reinsurance business by means of "pool" and "fronting" arrangements. On the other hand, the insurers might transfer their insurance risk to other unauthorised reinsurers through these fronting arrangements. As a result of legal disputes that may arise and that may endanger the solvency of insurers and fronting insurers, the appropriate regulation should be able to provide for monitoring these arrangements. It has been noted that the restriction on these arrangements might increase unnecessarily transaction costs and might have a significant impact on the reinsurers to accept insurance risk internationally. As a result, it is appropriate to require insurance undertakings to disclose all material and relevant information regarding any risk retention and the fronting arrangements.

IV. Issues of Finite Risk Reinsurance and Securitisation of Insurance Risk

In addition to traditional reinsurance, there are several alternative methods to transfer insurers' risk arising from operating and underwriting. Such alternative risk-financing techniques typically involve the funding of underwriting risk from life insurance or non-life insurance through capital market and investors. While the development of these risk transfer instruments has increased dramatically in recent years, this raises considerable concern for regulators, accountants, investors and insurers. As a result of lack of any relevant regulation and accounting principles to supervise these transactions in Taiwan, further suggestions are provided below in this section.

A. Finite Risk Reinsurance

In Taiwan, the definition of reinsurance is provided in Section 39 of the Insurance Law. According to this Section, reinsurance is an insurance contract, which assumes the "insured risk" of an insurer. Due to lack of any decisions made by the courts and of relevant regulations in Taiwan, it is problematic to define the meaning of "insured risk". From the viewpoint of insurance regulation, the main purpose is to ensure the adequacy of technical "provisions" and to prevent a misleading view of the financial condition of insurers if such a reinsurance contract does not transfer the underwriting risk significantly. As a result, it is suggested that the relevant regulations as to reinsurance should provide the following aspects.

1. The basic criteria relating to risk transfer should be developed and structured in the framework of solvency regulation

The basic criteria relating to risk transfer should be developed to enhance the transparency of the respective regulation for the insurers and reinsurers. The criteria should be based on the economic substance of transactions (such as US FASB 113). With regard to risk transfer criteria, it would be appropriate that timing risk alone is sufficient to constitute a reinsurance contract because the timing risk arising from the uncertainty of liability payment for policyholders will significantly affect the capacity of the ceding insurers. This will provide more flexible and less stringent regulatory requirements for insurers who suffer the timing risk arising from the assumed insurance risk. In addition to development of risk transfer criteria, it should be noted that the criteria based on the accounting principles should not be inferred as to what constitutes the reinsurance contract in law and only should be used to decide the relevant accounting and regulatory treatments.

2. The criteria should take into account the terms of the reinsurance contract as a whole

The issue relating to the economic substance of transactions should take into account the terms of contracts that may affect the loss payment from the reinsurers and further reinsurance premium to be paid by ceding insurers, *e.g.* experience account, the premium payable estimated by reference to a stated or implied interest rate, a return of profit commission, and cancellation or commutation provisions that would result in a loss to the ceding insurers. This should also take into account the terms of reinsurance contracts as a whole and the analysis of the financial outcome relating to this transaction, although this may increase the regulatory costs and may place an excessive burden on the regulators in monitoring and analyzing these transactions. As a result, the cooperation between auditors, tax authority and insurance regulators should be enhanced.

3. The security and the reliance of reinsurance should be ensured

While one of the characteristics of finite risk reinsurance is multi-year, the security of reinsurance transactions is the main issue relating to reinsurance regulation. These transactions often involve huge amount of reinsurance premiums and the payments will be distributed over several years. For example, under loss portfolio transfer agreements, the payment of reinsurance recoveries are structured on a financial loss and distributed along with the investment income during the covered period. So such, the financial condition of the reinsurer will have a significant impact on the reinsurance recoveries. Furthermore, the reinsurers who specialise in the area of finite risk reinsurance are often located and registered in less stringent regulated jurisdictions such as Bermuda and the Cayman Islands. All this has increased concerns for the security of reinsurance transactions. Therefore, the regulators should be placed in a position to assess the reliability of such a transaction and the financial solvency of the reinsurer.

4. The loss provisions should be sufficient to meet the liabilities from the policyholders

The adequacy of loss reserves should be considered even though the reinsurance transaction meets the risk transfer criteria. For instance, the main advantage of finite risk reinsurance is the reduction of loss reserves after finite risk reinsurance cover is provided. While the finite risk reinsurance may lead to inadequacy of loss reserves, it is essential to develop the methods to estimate the extra reserves and to analysis the possible effect of the specific terms of contract on an insurer's financial solvency.

B. Securitisation of Insurance Risk

While insurance securitisation transactions have created a worldwide insurance and reinsurance capacity through the issuance of insurance-linked securities, the regulatory infrastructure to facilitate and effectively to supervise these transactions still only has been developed in few countries. As the implementation of the new Taiwanese Securitisation of Financial Asset Act may facilitate the securitisation of assets and mortgages, it also offers the legal infrastructure for insurance securitisation transactions. From the viewpoint of insurance regulation, the following aspects should be considered if these on-shore transactions are permitted.

1. Securitisation transactions should be allowed under the relevant laws and regulations

First, the Taiwanese Insurance Law should be amended to allow the insurance company to engage in securitisation transactions. As a result of an ambiguity that investors engaging insurance securitisation transactions might be deemed as carrying on insurance business, the country could provide a specific statutory provision to define that the purchase of insurance-linked securities does not constitute the transaction of insurance business in order to clarify this legal uncertainty.

2. Special purpose reinsurers should be allowed to operate in Taiwan

Learning from the developed models of developed countries, the main focus of any regulatory infrastructure for insurance securitisation should be to develop the legislation to allow Special Purpose Reinsurers (SPRs) that can assume the insurance risk and can issue insurance-linked securities. To reduce transaction costs, it is suggested that the concept of the "protected cell" in the SPR can be adopted to allow these entities engage several transactions at the same time. Unlike other securitisation transactions where a SPV can be formed as a business corporation, a trust, or as a limited partnership, the SPR usually is formed as a corporate reinsurer that is authorised to assume insurance risk and to issue insurance-linked securities.

3. Requirements relating to collateral arrangements should be established

In general, a trust is established to hold the related collateral with certain restrictions on the investment activities of the trust. For example, the NAIC Protected Cell Company Model Act contains the provisions regarding the investment of the "protected cell" assets of SPRs. In relation to the security of the SPR, the basic risk should be considered particularly in the case of a "parametric trigger", because it may endanger the financial solvency of the ceding insurer as mentioned in Chapter Four. In addition to collateral requirements, the segregation of a "protected cell" would need external credit support to enhance the market acceptability of the insurance-linked securities and to ensure the financial solvency of a protected cell company.

4. The bankruptcy law relating to SPR should be amended

The bankruptcy system should be amended to accommodate the concept of a protected cell is introduced. The main feature of a protected cell in a SPR is to shield a protected cell account's assets and liabilities from the credit risk of the reinsurers in the case of insolvency (i.e., bankruptcy, remoteness). By introducing this concept, the relevant bankruptcy system should ensure that the protected cell of the SPR should not be affected by any order of conservation, rehabilitation or liquidation of a SPR.

5. Insurance supervisors should ensure their ability to supervise the offshore securitisation transactions

In addition to on-shore securitisation transactions, the insurance supervisors should be aware of offshore insurance securitisation transactions. The insurance supervisors should be able to assess the appropriateness of reinsurance and the securitisation transaction whether on-shore or off-shore. It is suggested that the assessment of these transactions should take into account with the operation and the corporate structure of the SPR, and the collateral arrangements relating to the securitisation transactions and reinsurance contracts.

V. Recommendations for Reinsurance Regulation Reforms in Emerging Market

As the regulators in emerging economies often face the dilemma between the diversification of risk and the security of the reinsurance, the development of *indirect regulation* as an appropriate approach to ensure the solvency of primary insurers is vital to promote the domestic insurance market[24]. Based on the study of reinsurance regulation reform in the Taiwanese insurance market, the author's modest recommendation for an appropriate reinsurance regulatory infrastructure more generally in emerging economies, would entail the following:

First, insurance regulations should provide a viable and comprehensive solvency regulatory regime to supervise and monitor the financial solvency of the insurers. Under such a framework, solvency regulation should further address the security of reinsurance and the creditworthiness/security of the reinsurers either in terms of statutory accounting requirements or in the required solvency margin. As a result, the evaluation of foreign reinsurers plays a vital role in this reinsurance regulation. It seems that the Mexican regulatory approach, which did improve the quality of reinsurance arrangements of primary insurers in Mexico, depend largely on the analysis by rating agencies without proper concerns the domiciled regulatory regime. Therefore, it is suggested that the cross-border cooperation between regulators should also be enhanced. In doing so, the accuracy of the evaluation can be improved, as well as, can be the solvency of primary insurers. In addition to the evaluation of reinsurers, all the reinsurers should be subject to appropriate regulation in the domiciled country, where the regulatory regime is able to ensure the financial solvency of reinsurers and the fitness and propriety of management. Furthermore,

[24] *See generally* Chapter 2.

good corporate governance and sound internal controls should be introduced and implemented in the process of the reinsurance arrangements for the primary insurers.

Second, with regard to the regulation of reinsurance intermediaries, three fundamental issues, which include the licensure requirements, market conduct of intermediaries and the separation of insurance monies from the general account of intermediaries, should be carefully considered. The licensure requirements should include the criteria concerning the fitness and propriety of management, adequacy of capital and professional indemnity insurance to meet the liabilities arising from the operation of relevant business and the specified requirements for the reinsurers. In addition to the licensure requirements, the regulation should provide principles to ensure the reinsurance intermediaries exercise "reasonable care and skill" in carrying on its business. In order to protect the interests of the principals (e.g., reinsurers or primary insurers), an approach regarding the establishment of a specific, segregated account can be adopted to ensure that in the event of bankruptcy of intermediary these accounts will not be used to reimburse other creditors.

While the increasing use of financial reinsurance in emerging markets raises considerable concerns, it would be difficult to establish an appropriate criteria concerning the relevant regulation without comprehensive statutory accounting principles. It is suggested that the statutory accounting principles should be able to reflect the accurate evaluation of the financial condition of the primary insurers. Consequently, the criteria concerning the risk transfer should be set out as well as the sufficiency of loss provisions.

As the securitisation of insurance risk has significantly provided alternative capital derived from the capital market, it is likely that emerging economies should follow this path to look for additional risk transfer means, particularly in these emerging markets with a basic securitisation regulatory infrastructure (e.g., Chile[25]). To create the appropriate legal infrastructure, the law should allow the Special Purpose Reinsurer to assume insurance risk and to issue insurance-linked securities. In addition, it is essential that the collateral arrangements and the restriction on investment activities should be established to bloster the financial solvency of the

[25] *See generally* JOSEPH J. NORTON, FINANCIAL SECTOR LAW REFORM IN EMERGING ECONOMIES 252 (2000).

SPR. In the case of off-shore securitisation transactions between the primary insurer and the SPR, the regulators should ensure the ability to assess these transactions and to take into account the corporate structure and financial condition of the SPR and the relevant collateral arrangements.

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